APPENDIX

Decision of Referee Costa Denying the Counterclaim of the Trustee in Bankruptcy Dated September 30, 1965

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF NEW YORK

63 B 105

[SAME TITLE]

APPEARANCES:

POPPER & POPPER, Esqs., Attorneys for Trustee. By: Abraham Popper, Esq., of Counsel.

LOUIS P. ROSENBERG, Esq., Attorney for Gibraltar Factors, Inc.

PLEADINGS & PROCEEDINGS:—

For brevity when reference is made to minutes of 3/22/65 the Pages will be indicated ( ) otherwise the date and Page will be indicated.

An involuntary petition was filed against Hygrade Envelope Corp. (Hygrade) the bankrupt on January 24, 1963.

In response to a motion made by Gibraltar Factors Corporation (Gibraltar), before my esteemed predecessor, the late Hon. Louis J. Castellano, Referee in Bankruptcy, for an order directing the Receiver, who was subsequently succeeded by the Trustee as the respondent on that motion, to surrender certain machinery, the trustee filed an answer and counterclaim. In addition to denying the 7th paragraph in the moving petition, which paragraph dealt with

amount alleged to be due to Gibraltar and secured by certain chattel mortgages the trustee's answer set up separate defenses and a counterclaim as follows:—

2) That on or about November 26, 1962 Gibraltar Factors, the petitioner herein, received preferential transfers and assignments in that on or about that date it received transfer of an insurance policy and in addition a chattel mortgage in the sum of $15,000.00, which said transfers were made on account of antecedent debts of the bankrupt.

3) That at the time of the said transfers the bankrupt was insolvent.

4) That at the time of the said transfers the said Gibraltar Factors Corporation knew and has reasonable cause to believe that the bankrupt was insolvent.

5) Upon information and belief that as a result of the said Transfers the said Gibraltar Factors Corporation received for account of its antecedent debts upwards of the sum of $105,000.00.

Thereafter an order on consent was entered by Referee Castellano whereby the premises and chattels of the bankrupt were surrendered to Gibraltar subject to certain conditions, the one pertinent to the controversy before me, providing:—

> That Gibraltar Factors Corporation remains under the jurisdiction of this Court and responds to any orders or decrees that may be entered herein respecting any claims, offsets or counterclaims, as reflected in the answer dated March 5, 1963, a hearing thereon to be had upon written notice.

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By private sale the machinery was converted to cash by Gibraltar (trustee's Ex. 3).

Thereafter on due notice to all interested parties the issues raised by the petition, answer and reply were brought on for hearing before me.

Prior to the hearing, pursuant to Rule 36 of the Rules of Civil Procedure for the United States District Courts, the trustee served Gibraltar with a request for admissions of the following facts:—

1) That on November 26, 1962 a policy of Life Insurance issued by National Life Insurance Company on the life of Jack Wohl for the face amount of $100,000.00 was assigned by Hygrade Envelope Corporation, the above-named bankrupt, to Gibraltar Factors Corporation.

2) That the beneficiary under the said policy of life insurance was Hygrade Envelope Corporation, the above-named bankrupt.

3) That the above-named bankrupt, Hygrade Envelope Corporation, was the owner of the said policy.

4) That at the time of the assignment of the said policy, namely, on November 26, 1962 the above-named bankrupt, Hygrade Envelope Corporation, was insolvent.

5) That at the time of the said assignment of the said policy, namely, on November 26, 1962 Gibraltar Factors Corporation knew that the said Hygrade Envelope Corporation was insolvent.

6) That the said assignment of the said insurance policy was made on account of antecedents debts of the above-named bankrupt to the said Gibraltar Factors Corporation.

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By response Gibraltar admitted items 1, and 3 and denied items 2, 4, 5 and 6 of said requests as above enumerated (3-4).

The issues thereby joined and upon which this Court must pass and decide are:—

1. Was the bankrupt herein insolvent on November 26, 1962?

2. If it is found that the bankrupt was insolvent on said date did Gibraltar have knowledge of the same or did it have reason to believe that Hygrade was insolvent on the crucial date?

3. Was the assignment, on November 26, 1962, by the bankrupt to Gibraltar of a policy of Life Insurance issued by National Life Insurance Company on the life of Jack Wohl, bankrupt, Vice President for the face amount of $100,000.00 in which policy Hygrade was the beneficiary a preferential transfer and assignment and made on account of antecedent debts?

4. If the aforesaid transfer and assignment was a preferential one and made on account of antecedent debts to what extent and in what amount was Gibraltar so preferred?

At the outset of the hearing the parties stipulated that the trustee's prayer for relief was to be fixed at the sum of $105,000.00 (2).

FINDINGS OF FACT:—

From 1955 to the date of the filing of the petition herein, January 24, 1963 Gibraltar advanced sums of money to

Hygrade pursuant to the terms of a financing agreement on a security basis, chattel mortgage, inventory lien and accounts receivable (s.m. P. 2-3 10/30/63).

Jack Wohl the Vice President of Hygrade was also general manager and factotum of the Company and it is agreed upon by all witnesses questioned on this point that he was the "Key Man" in Hygrade's operation.

From the inception of this factoring relationship Gibraltar required and obtained as additional security insurance on the life of Jack Wohl and originally obtained an aggregate of $100,000.00 life insurance represented by two $50,000.00 policies, one was a reducing policy (130-131-141).

At the outset the limit of credit extended by Gibraltar to Hygrade under the financing agreement was $100,000.00 and over the years this amount grew until in November 1962 it had grown to between $300,000.00 and $400,000.00.

In November 1962 the amount of life insurance held by Gibraltar on the life of Jack Wohl had been reduced to $72,000.00 (s.m. 10/30/63 Pg. 15).

That on November 26, 1962 Hygrade was indebted to Gibraltar in an amount in excess of $300,000.00.

On or about November 26, 1962 Gibraltar ascertained that one of the accounts receivable, designated as Avrec, assigned to it by Hygrade denied that the amount claimed to be due was in fact due to Hygrade.

The methods or custom of billing by Hygrade were two, the first, where the driver brought back a signed shipping receipt an invoice was prepared and sent to the customer; the second, where the order was received in writing or by phone and only part of the order shipped and the balance

invoices marked "Hold for shipping instructions" and the merchandise shipped later but the customer was billed for full amount of the order, both types of billing were considered accounts receivables and listed as such on the schedules sent to Gibraltar. The latter orders had always been eventually filled (50 to 53 inc.).

The schedule of accounts receivable furnished by Hygrade to Gibraltar as those assigned under the factoring agreement listed the full amount due from the customer as though the entire order had been filled and the full selling price due thereon and did not differentiate as to the type of invoice billing used for a particular account (50).

On November 26, 1962 when confronted by Mr. Hurwitz of Gibraltar Mr. Wohl of Hygrade admitted that the Avrec account was not accurate as to amount due since certain of the invoices to that account were marked "Hold for shipping instructions". Wohl indicated that this was not unusual and that such orders are thereafter filled from inventory and he had sufficient inventory to cover this order (128-129).

That the agreement between the parties entitled Gibraltar to audit the books of Hygrade which it did periodically either every 30 or 60 days and Gibraltar contends that these audits indicated a solvent condition, no irregularities concerning accounts receivable and a profitable operation (66-67).

On November 26, 1962 Gibraltar regarded Hygrade as solvent based upon a financial statement received by it as late as September 30, 1962 (s.m. 10/30/63 Pg. 22).

This report (trustee's Ex. 5 3/22/65) shows an excess of assets over liabilities and a net worth as of 9/30/62 of $108,826.00.

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On or about November 26, 1962 after the conversation between Hurwitz & Wohl, Gibraltar reviewed its security holdings on the Hygrade account, ascertained that its life insurance security had been reduced from $100,000.00 to $72,000.00 and demanded additional insurance. Wohl not wanting Hygrade to incur the expense of an additional premium offered to assign a life insurance policy held by Hygrade on his life to which Gibraltar agreed.

The assignment of the policy was made on November 26, 1962, said policy being one issued by National Life Insurance Company on the life of Jack Wohl in the face amount of $100,000.00 in which policy Hygrade Envelope Corporation was named as beneficiary.

On November 26, 1962 the cash surrender value of said policy was $393.00.

Jack Wohl died suddenly on December 5, 1962 (35). As a result of Jack Wohl's death Gibraltar collected $105,000.00 from National Life Insurance Company on the policy above mentioned.

The Federal income tax returns of the bankrupt for the fiscal years ending October 31, 1959, October 31, 1960 and October 31, 1961 and the balance sheet prepared by bankrupt's auditors as of October 31, 1961 indicated an excess of assets over liabilities and except for the fiscal year ending October 31, 1959 which showed a profit of $499.25 the year ending October 31, 1960 showed a loss of $38,403.32 and the year ending October 31, 1961 showed an operating loss of $35,016.99 (Gibraltar Ex. D erroneously marked for identification agreed upon by parties as in evidence see letter in file of Louis P. Rosenberg dated July 6, 1965.)

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The balance sheet prepared after the filing of the petition in March 1964, by the Court appointed CPA from Hygrade's books and records indicated that as of November 26, 1962 the liabilities exceeded assets by $150,349.59, which was the basis for his conclusion that as of that date Hygrade was insolvent.

On November 26, 1962 Gibraltar advanced $12,500.00 to Hygrade and from November 26, 1962 to the date of filing the petition Gibraltar advanced to Hygrade a total of $52,417.00 (Gibraltar Ex. E and 146).

CONCLUSIONS OF LAW

The Bankruptcy Act. Sec. 60(a)(1) defines a preference as a transfer "of any property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor *while insolvent* and within four months before the filing * * * the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class" Sub. (b) of the said Section provides "any such preference may be avoided by the trustee if the creditor receiving it is to be benefited thereby * * * has, at the time when the transfer is made, *reasonable cause to believe that the debtor is insolvent.* (Italics supplied.)

The burden of proving every one of these elements, by a preponderance of the evidence, is upon the trustee. Inter-State National Bank of Kansas City v. Luther, 221 F.(2) 383 Cert. dismissed, 350 U. S. 944; Vance v. Dugan, 187 F.(2) 605.

The petition herein having been filed on January 24, 1963 and the assignment creating the alleged preference

having been made on November 26, 1962, I find that the transfer was made within the prescribed four month period.

On the issue of insolvency the trustee called Sheldon Goldberg, an accountant for Gibraltar but not a CPA. Through this witness the trustee established that from June 1, 1961 through October 30, 1962 Gibraltar caused examinations of Hygrade's books to be made every month or month and a half (65). These audits or examinations consisted of a review of the accounts receivable ledger and a reference made to the cash book to ascertain whether Hygrade received any moneys on the accounts receivable assigned to Gibraltar. On none of the occasions of his examination did he suspect or was there any reason to suspect that any of the accounts receivable were not bona-fide (65-66). No balance sheet was struck by Goldberg or any other Gibraltar employee to his knowledge from Hygrade's books, however Gibraltar did receive from Hygrade a balance sheet for the year ending October 30, 1961 prepared by Hygrade's accountants, but none for the year 1962 (66-67).

The next witness on this crucial issue was Irwin Lutsky a CPA affiliated with Roberts & Leinwander, the accounting firm authorized by the Court order to make an audit of the bankrupt's books. This audit was made in March 1964 and for the purposes of this hearing he confined his figures and findings to "as of November 26, 1962". He concluded that on his audit and resulting balance sheet Hygrade, on November 26, 1962, was insolvent since its liabilities exceeded its assets by $150,349.59 (87). It is to be noted that in arriving at his conclusion he made certain adjustments by the use of what he termed as standard accountancy procedures such as aging accounts receivable

taking into consideration the rate and extent of collections since the filing to the date of making his audit and a 120 day non-payment period which under all circumstances caused a reduction in the account receivable item in the assets column of over $100,000.00. Other adjustments were also made which when added together exceeded the $150,349.59 excess of liabilities over assets. On cross examination this witness admitted that if the balance sheet had reflected the condition as ascertained strictly from the books without any adjustments it would result in an excess of assets over liabilities and hence a solvent corporation (119-120).

On the theory that if the creditor had reason to believe that the debtor was insolvent its inquiry into that question would be made on his behalf by a competent auditor who would use the same standard procedures and adjustments as did Lutsky, I held at the close of this phase of the trustee's case that there was a prima facie showing of insolvency (120-121) and on that basis I now so hold. In arriving at this conclusion I have in mind the income tax returns and the balance sheet as of September 30, 1962 all of which indicated a solvent condition, notwithstanding the attack made by the trustee in his memorandum, on the inventory figures used in the balance sheet and also the fact that no irregularities were revealed in the different examinations made regularly by Gibraltar of Hygrade's books. True a slim showing but nevertheless a showing sufficient to find that the trustee had sustained his burden on this phase of his case.

Turning then to the issue of whether Gibraltar had knowledge of, or had reasonable cause to believe that Hygrade was, insolvent. Trustee concedes that Gibraltar

did not have actual knowledge (122) his statement on the record is:—

> "Mr. Popper: I am not contending actual knowledge. I do not pretend to draw a picture of their mind. I say there were so many facts before them that put them on inquiry".

Although in his memorandum he seeks to hedge on the concession by stating that "having no means of proving the state of the factor's mind, the trustee did not choose to affirmatively assert such knowledge", which is obviously an enigmatic repetition of the record concession. In any event the record is bare of any proof of actual knowledge and his attempt to make figures testify favorably by attacking the inventory figures used on line 56 of Exhibit 5 is unrealistic and not convincing especially in view of the fact that when all of the testimony on inventory is considered the figure used on line 56 of Ex. 5 is a realistic one. Argument is not evidence.

When requested to indicate where in the case, as far as it had gone and he had rested, had he shown facts that put the factor "on inquiry", he referred to two 21a examinations of Hurwitz previously marked in evidence without indicating the pertinent portions thereof. I advised him that this was not procedurally correct since it did not give his adversary the opportunity of cross examination and of presenting rebuttal testimony or evidence. With the consent of his adversary I permitted the re-opening of his case and Hurwitz was called as a witness.

The "so many facts before them that put them on inquiry" substituted by the trustee in place of the statutory requirement of "reasonable cause to believe" is sought to be sustained by a testimony analysis of Hurwitz's testimony. A profusion of semantics was engaged in by coun-

sel in this case, reference being made to the Avrec account as a fictitious, fraudulent, non-existent, phony, bum and pre-billed account. While the trustee repeatedly referred to and insinuated that there were other fictitious accounts, than the Avrec one, there is no proof in the record to this effect. There is evidence of 2 invoices of another pre-billed account (trustee's Exs. A & B for Ident. 52) but these were referred to as an example of what a "Holding for shipping instructions" invoice consisted of and to exemplify Miss DeJoseph's description of the firm's custom and usage of the pre-billing system.

The record is replete with insistences by Hurwitz both in his testimony before me and in his 21a examination transcripts in evidence that Wohl informed him that the Avrec account was a pre-billed account, that Avrec was a regular customer with which Hygrade had dealt and was still dealing with, that this was the only one to Hurwitz's knowledge on November 26, 1962, although after November 26, 1962 Wohl told him about other pre-billed accounts.

By a devious but readily recognizable method of examination of a witness the trustee seeks to convince the Court that there were, and Gibraltar had knowledge of, the existence of more than one questioned account shortly before or on November 26, 1962.

After questioning the witness on an accounting problem an immediate switch is made to a topic not related to the last question and answer and the question asked by Mr. Popper:—Pg. 127

> "Q. And you testified, after discovering that you had been given non-existent *accounts* receivable, you received an assignment of the policy for $100,000.00? A. That is right." (Italics supplied.)

That question was asked notwithstanding the fact that throughout his prior testimony Hurwitz had up to that time never mentioned any account other than Avrec and that Wohl had explained to him that this was a pre-billed account. When I proceeded to attempt to clarify the actual fact and asked the following question intending to follow it by a specific question as to the number of accounts he was aware of, the result was as follows: Pg. 128

> "The Referee: Did you know of these non-existent *accounts* before?
>
> The Witness: I knew of one particular account."

The evidence is clear that the Avrec account was neither a fraudulent, phony, bum or non-existent account, it was, as Miss DeJoseph's and Wohl termed it a pre-billed account with a "Holding for shipping instructions" designation. The record is clear as to the usage of this system and is also bare of any evidence that these orders were not eventually actually filled. From the record there is no doubt about the fact that this was the first such incident in seven years of dealings between the parties.

The discovery by Hurwitz of some other pre-billed accounts did not occur until December or January or February of 1963.

In a recent decision in this circuit Kravetz v. Joange Bldg. Corp. 341 F(2) 561 decided February 16, 1965, a consideration of the "reasonable cause" provision was involved and defined. Judge Moore wrote at Page 563

> "A creditor has reasonable cause to believe that a debtor is insolvent when such a state of facts is brought to the creditor's notice, respecting the affairs and pecuniary condition of the debtor, as would lead a prudent business person to the con-

> clusion that the debtor is insolvent." 3 Collier, Bankruptcy ¶60.53(1) at 1057-58 (Moore & Oglebray 14 Ed 1964)

In the Kravetz case, supra, the Court found that "the facts undisputedly known by Joange (the creditor) more than met the requirements of reasonable belief". Reasonable cause must be viewed and interpreted in the context of the known and undisputed facts, circumstances and surroundings. Moran Bros. v. Yinger 323 F(2) 609; Mayo v. Pioneer Bank & Trust Co. 190 F. Supp. 151, 157. Reasonable cause to believe is not the same as reasonable cause to suspect. Grant v. First National Bank 97 U. S. 80. Here under the facts, circumstances and surroundings, there may be at best have been a suspicion but I cannot find such a state of facts, brought to the creditors attention, respecting the affairs and pecuniary condition of the debtor, as would lead a prudent business person to the conclusion that the debtor is insolvent.

The record clearly indicates that Gibraltar had been doing business with Hygrade for about seven years, Gibraltar conducted regular checks of Hygrade's books; during this period Hygrade's business had increased almost fourfold and gradually Gibraltar's limit of credit to Hygrade had increased from $100,000.00 to over $300,000.00; that a check of Hygrade's books reflected the accounts receivable; that whatever balance sheets were available reflected a solvent corporation; that a system of pre-billing was used by the debtor with no indication that there had ever been a failure on its part to fill the orders and a positive statement by Miss DeJosephs that they were always completed and that the schedule of assignment of accounts furnished by Hygrade to Gibraltar had annexed to it duplicate of the invoices.

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On the other hand the trustee urges the discovery by the creditors of a pre-billed account of an existing customer of long standing, the first in seven years, and operating losses in two out of three years as reflected in the bankrupt's tax returns and that after a crediting of depreciation and other standard allowances. Obviously an imbalance of the evidence on this issue and a falling short of a preponderance of the evidence which is the trustee's burden.

On the part of the trustee there is an absence of substantial evidence to sustain his position and this is a pre-requisite to a finding in his favor on this issue. Consolidated Edison, N. L. R. B. 305 U. S. 1977.

On the record I find that the trustee has failed to sustain his burden of proof that at the time of the assignment of the insurance policy Gibraltar knew or had reasonable cause to believe that the bankrupt was insolvent.

The knowledge or reasonable cause to believe that the debtor is insolvent being a pre-requisite to the establishment of a preference within the meaning of Sec. 60A(1) of the Bankruptcy Act, and having found that the trustee has failed to prove said pre-requisite, I do not deem it necessary to pass upon the remaining issues of antecedent debt or extent of recovery.

The relief requested by the trustee as set forth in his answer and counterclaim is denied. Settle order on 3 days' notice.

Dated, Brooklyn, New York, September 30, 1965.

JOSEPH V. COSTA
Referee in Bankruptcy

Referee's Decision on Remand Dated April 17, 1967

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF NEW YORK

[SAME TITLE]

On appeal from an order of the District Court, affirming my original order dismissing the counterclaim by the trustee that Gibralter had received a preferential transfer, both the District Court and I were reversed and the allowance of the trustee's counterclaim was directed. 366 F(2d) 584.

On a petition for rehearing the opinion of the Court, as cited, was modified by an opinion and order dated September 28, 1966, and the matter remanded for the Referee to "make further findings and conclusions on the issues reserved by him." These issues not originally passed upon, because of the previous holding by me, and as set forth in the amending clause (3) of the decision of the Court of Appeals are:

(a) Whether the transfer was for or on account of an antecedent debt, Sec. 60a(1) of the Bankruptcy Act, and

(b) Whether, if the transfer was preferential, Gibralter is entitled to a set-off under Sec. 60c(8) of the Bankruptcy Act.

I am also requested to consider a claim by Gibralter, raised for the first time on its petition for rehearing, that the policy on Wohl's life, assigned by Hygrade to Gibralter on November 26, 1962, was exempt property under the

Referee's Decision on Remand

New York Insurance Law, Sec. 166(1) and that its proceeds were therefore not recoverable despite the proviso of Section 6 of the Bankruptcy Act, "If this point remains relevant," in the light of my other Findings and Conclusions.

Since the remand, by agreement between the parties and with the consent of the Court, the parties have filed a stipulation dated November 7, 1966, providing that, "The Court's determination in accordance with the remand directed by the United States Court of Appeals would be based upon the record taken at the trial of the issues held on March 22, 1965" to be supplemented by four additional exhibits described in the stipulation. Further, the parties have submitted proposed Findings of Fact, neither of which I am adopting, and also submitted their respective memoranda of law on these issues.

Notwithstanding the stipulation on the record that the trustee's prayer for relief was to be fixed at $105,000 (sm. 3/22/65 p. 2 and Findings of Fact 12/30/65 p. 5), the parties now agree that it is to be fixed at $101,000.

I set this matter down for further hearing or argument today. It appears from the memoranda submitted that no further hearing is necessary, except, that if the Court finds that the assignment of the policy was made partly for an antecedent debt and partly for a present consideration, a hearing might be held, if the record is not deemed presently sufficient to enable Gibralter to prove the extent of its set-off, if any.

As to the set-off claim of Gibralter, the trustee argues that under the issues as framed by these pleadings Gibralter has no right of set-off. Gibralter argues that it has and asserts that the trustee recognized a right of set-off

in his answer filed in this proceeding. The Court shall, within its equity powers, look to substance rather than to form and it is of the firm opinion that the Court of Appeals in its remand order intended that the issue of set-off, if any, be considered.

Upon the record of all of the pleadings and proceedings heretofore had herein, I make the following supplemental findings of fact and conclusions of law:

Findings of Fact:

In this opinion, figures in parenthesis refers to stenographer's minutes of 3/22/65.

1. That on November 26, 1962, Hygrade was indebted to Gibralter in the amount of $385,752 (Exhibit 4) and the assignment of the insurance policy, on the life of Jack Wohl, was made as security for and because of the outstanding obligation of Hygrade to Gibralter of between $300,000 and $400,000, an antecedent debt.

2. That on November 26, 1962 Gibralter had reason to believe that the debtor, Hygrade, was insolvent.

3. That the assignment was made within four months of the filing of the petition herein.

4. That the assignment enabled Gibralter to receive on its antecedent debt a greater percentage than other creditors of the same class.

5. That the transfer of the insurance policy diminished and depleted the assets of Hygrade.

6. That on November 26, 1962 Gibralter advanced to Hygrade $12,500, for which it obtained a chattel mortgage in the amount of $15,000 as security.

7. That from November 26, 1962 to the date of the filing of the petition, January 24, 1963, Gibralter continued to factor accounts receivable for Hygrade to the extent of $52,417, for which Gibralter received assignments of accounts receivable and an additional chattel mortgage mentioned in the Findings of Fact number 6. By stipulation the record is to read that the advances during that period amounted to $60,917. (Exhibit K)

8. That between November 26, 1962 and February 8, 1963 the indebtedness of Hygrade to Gibralter was reduced by $247,403, which included the proceeds of the insurance policies, the balance being realized from the collection of accounts receivable. The balance due on that date from Hygrade to Gibralter was $138,349. (Exhibit H)

9. That after the death of Jack Wohl on December 5, 1962, Gibralter received the sum of $101,000 as the proceeds of the insurance policy.

10. That the advance made by Gibralter to Hygrade on November 26, 1962 of $12,500 was not a present consideration for the assignment of the insurance policy, nor were the future advances made or given in good faith without security of any kind for property which became a part of the debtor's estate.

11. That the assignment of the insurance policy from Hygrade to Gibralter on November 26, 1962 was not made with actual intent to hinder, delay or defraud creditors as

such actual intent is defined by Article 10 of the Debtor and Creditor Law of the State of New York.

CONCLUSIONS OF LAW:

The order of remand suggests the consideration of the claim of Gibralter, not made in the original proceeding but raised on the appeal, "That the trustee is not entitled to recover because the insurance policy was exempt property under New York Insurance Law Sec. 166(1), if that point remains relevant."

Obviously that claim and the issue created by it is not only relevant but material and necessitates immediate consideration. The decision of this issue could well be dispositive of all remaining issues.

The learned Judges above were "not satisfied that the arguments presented in the petition for rehearing, the answer and the reply are adequate for proper disposition" of the claim of exemption.

As previously noted, no affirmative claim of exemption is made by the factor in the original pleadings. However, the question is one of procedure and not one of substance. No statute of limitations is urged by the trustee, rather he argues to the point in his memoranda. Had the claim been made on the original hearing before me I would have been constrained to allow proof thereon and decided it, especialy under the present trend toward liberal procedure and adherence to substance. In the interest of orderly procedure and to avoid a fragmentation thereof, I shall pass upon this issue at the outset.

In its petition for rehearing and brief in support thereof in the Court of Appeals, and in its memorandum of law in

this proceeding, Gibralter claims that the policy of insurance was exempt property under Sec. 166(1) New York State Insurance Law and, as such, was not property with which the trustee could become vested. (Sec. 67D, 107D and 70 of the Bankruptcy Act).

The pertinent portion of Section 166(1) is the third sentence which provides:

> "If any policy of insurance has been or shall be affected by any person on the life of another person in favor of a third person beneficiary, or made payable by assignment, change of beneficiary or otherwise, to a third person, such third person beneficiary, assignee or payee shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in State and Federal Courts of the person insured and of the person effecting the insurance."

Under Section 37 of the General Construction Law of New York State, the term, "person" includes a corporation.

In this case Hygrade "effected" the insurance on the life of Whol, made payable by assignment to Gibralter, so that all three specifications prescribed in the third sentence of Section 166(1) are present.

Section 6 of the Bankruptcy Act provides:

> "This act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State Laws in force at the time of the filing of the petition in the state wherein they have had their domicile for the six months immediately preceding the filing of the

> petition, or for a longer portion of such six months than in any other state; provided, however, that no such allowance shall be made out of the property which a bankrupt transferred or concealed and which is recovered or the transfer of which is avoided under this Act for the benefit of the estate, except that, where the voided transfer was made by way of security only and the property recovered is in excess of the amount secured thereby, such allowance may be made out of such excess."

It is noted that the "proceeds and the avails" of the policy is the entitlement of the "third person, beneficiary, assignee or payee," Gibralter in this case, as against the creditors, personal representatives, trustees in bankruptcy, etc. of the person insured (Wohl) and of the person affecing the insurance (Hygrade).

It has long been recognized that there is a difference between a voidable preference and a fraudulent transfer. *United Pacific Insurance Company* v. *First National Bank*, 222 F. Supp. 243; *In Re White*, 221 F. Supp. 937.

There is no claim here of fraudulent transfer so that the cases of *In Re White* and *In Re Martin*, cited by the trustee, are not apposite.

Paragraph 4 of Section 166 of the Insurance Law of New York State provides for the voiding of a fraudulent transfer and accords to the creditors all the remedies provided by Article 10 of the Debtor and Creditor Law, Section 270 et seq. The section is silent as to a similar remedy for exempt property such as insurance. It has been consistently recognized that a transfer of exempt

property cannot constitute a voidable transfer recoverable by a trustee.

Burlingham v. *Crouse,* 228 U.S. 459
Kilgo v. *United Distributors,* 223 F(2) 167, Cir.
Hogen v. *Hull,* 118 Fed (2) 247.
Re Rubin, 29 Supp. 416 (SDNY).
Collier on Bankruptcy (14 Ed.) Sec. 6.11 pp. 847, 849.
3 *Collier on Bankruptcy* (14 Ed.) Sec. 60.25 p. 879.

The trustee in his memorandum appears to agree with the contention that an exemption is accorded the insurance policy under Section 166 of the Insurance Law but argues, with a reliance on Judge Learned Hand's opinion in the case of Negin v. Saloman, 151 F(2) 112, that it is a voidable preference within the proviso of Section 6 of the Bankruptcy Act. He cites the revered Judge's statement at page 113 and I shall quote what I deem to be the crux of his holdings at that page:

> "*The theory seems to be that* a bankrupt may not convey exempt property to defeat the purposes of the Act, and that the transfer is a surrender or 'waiver,' of the exemption."

The learned jurist's observation here is obviously dictum and from a reading of the ultimate holding in that case did not require an adjudication of that issue. I am also mindful that frequently Judge Hand's dicta have been resolved as the law on the issue on which he expresses a mere opinion.

In Kilgo, the Court considered and cited Negin as authority for recognizing and giving full scope to State exemption laws. The Court in Negin held that the amend-

ment of the Bankruptcy Act of 1938, Section 6, did not change or affect the law as it was prior to the amendment, namely, that a transfer of exempt property is not a voidable preference, particularly since Secs. 67(d) and 107(d) of the Bankruptcy Act expressly exclude exempt property, and that Secs. 70(a) and 110(a) specifically provide for the vesting in the trustees of title only to *non-exempt property.* (Italics supplied.)

True, a hurried reading of Sec. 6 of the Act would seem to indicate that a change was intended so as to make preferential transfers of exempt property recoverable by the trustee. But a close examination of the section, especially the proviso portion, is conclusory of the fact that such is not the case. Also a study of Judge Hand's entire opinion discloses no conflict with Negin. Collier reports that prior to the 1938 Act a preference of exempt property was not voidable and further that there is nothing in the present Act that qualifies the prior holdings.

Colliers 14 E.D. Sec. 6.11 pp. 847, 849, *supra.*

The relevant proviso portion of Sec. 6 provides, "that no such *allowance* shall be made out of the property—the transfer of which is avoided under this Act." (Italics supplied.)

What allowance is meant? Obviously "the allowance to bankrupts of the exemptions which is prescribed by laws of the United States or by the state laws," as prescribed in the first part of Sec. 6.

The reason and logic underlying this conclusion, as stated by Collier in Volume 1, 14 E.D. 6.11 at p. 853 is: "It was believed by the framers of the Act that a bankrupt

should not profit at the expense of the creditors from the efforts of the trustees in undoing the bankrupt's own acts." See analysis of H. R. 12, 889, 74th Congress 2d session (1936), 28. The statement made by Mr. Watson B. Adair, Member of the National Bankruptcy Congress, in House hearings on H. R. 6439, 75 Cong. 1st Sess. (1937) 39, referring to the amendment to Sec. 6 of the Act, is to the same effect, although the trustee reads it to the contrary. After referring to the section as the "only important new provisions", he stated, "it is merely that it is inequitable that a bankrupt, who has transferred his property, should benefit by the action of the trustee in setting aside that transfer, and take away the fruits of the trustee's labor." Clearly, the purpose of the amendment was to deprive the *bankrupt* of the "allowance" and not to create a new right in the trustee in contravention of existing law.

Sec. 70(a)5 of the Bankruptcy Act, as quoted by the trustee, is not applicable under the facts in this case since that section merely prescribes the right of the trustee in the event that a policy is one of the assets of the estate.

Read in this light there appears to be no conflict or contradiction between the Bankruptcy Act or the State Statute, nor is there a dichotomy between Kilgo and Negin, as urged by the trustee.

I therefore conclude as a matter of law that the insurance policy in question is exempt property covered by Sec. 166(1) of the Insurance Law of the State of New York and that the trustee cannot void the assignment thereof as a voidable preference under any of the applicable sections of the Bankruptcy Act.

Referee's Decision on Remand

Ordinarily, in view of my conclusion of law, holding the insurance policy exempt and not available to the trustee, I would not be called upon to decide the remaining issues. However, this case has been a protracted and hotly contested one, with the contests being justified. It was begun in January 1963 before my esteemed predecessor, the late Honorable Louis J. Castellano, Referee in Bankruptcy.

I am mindful of the rights of review and appeal of the respective parties and of the fact that a contrary legal conclusion could be ultimately reached on my first conclusion of law, leaving the remaining important issues unresolved.

In the interests of the desired proper and prompt administration of bankrupt estates I believe it necessary and expedient to pass upon these issues now so that my decision might be available to any reviewing forum for whatever use it might then be deemed advisable.

I conclude that the transfer of the insurance policy, from Hygrade to Gibralter, was a preference within the purview of Section 60B of the Bankruptcy Act and was not made for a new and present consideration but was additional security for a past indebtedness. The Court of Appeals' decision reported in 366 F(2) 584 established as a matter of law that Hygrade was insolvent on November 26, 1962 and that Gibralter had reasonable cause to believe that the debtor was insolvent.

In its petition for rehearing in the Court of Appeals the Respondent (Gibralter) cited one of my original findings to the effect that Wohl, not wanting Hygrade to incur the expense of an additional premium, offered to assign a life insurance policy held by Hygrade on his life, to which Gibralter agreed, and I did so find. However, that

was not proof of the fact, as Gibralter argues, that the assignment was made for a new and present consideration. The evidence is preponderant and convincing that the assignment was made as security for the existing indebtedness. In my supplemental findings, numbers 1 and 10, I have made the additional findings pertinent to this issue.

The record is replete with the repetitive testimony of Hurwitz, in his 21A examination (pp. 18-A and 19-A) and on the hearing held on March 22, 1965, to the effect that when Gibralter learned of the pre-billed Avrec account he consulted with his superior; reviewed the Hygrade account; found that Hygrade was indebted to Gibralter for between $300,000 and $400,000 and demanded more insurance. Why was the additional insurance demanded and eventually delivered? The evidence is clear that it was to secure the outstanding indebtedness. True, after this item was disposed of Gibralter considered making additional advances, but nowhere in the record is it indicated that the future advances were made against the additional insurance as security for them. For the advance of $12,500 made on November 26, 1962, the factor obtained an additional chattel mortgage in excess of the amount of that particular loan. At the time of the additional advances were made Gibralter had a merchandise inventory lien, chattel mortgages on the equipment and assigned accounts receivable. While Wohl was still alive and subsequent to his death Gibralter contained to receive accounts receivable against which there was no claim of their being non-existing or "bogus" as Hurwitz termed the Avrec account. Quite significant is the Hurwitz testimony at page 132 where reference is being made to the happenings on the day that Wohl came to deliver the additional policy. He testified:

> "The Witness: We gave him on that day that he brought it in he asked for *additional advances on the*

> *security he had,* there is a mortgage on that day when he advanced him $12,500." (Italics supplied.)

This testimony when added to his testimony at page 153 is quite conclusive on this issue. It is admitted and I have found that the cash surrender value of the policy on November 26, 1962 was $393.00. In his argument on the issue of depletion of the debtor's assets, Gibralter's attorney urges the de minimis rule and concludes that the depletion, if any, was minimal and should not be considered as a depletion of assets. However, no reference is made to this fact on the issue of present consideration. Does counsel seriously contend that the factor made advances of some $34,100 between November 26, 1962 and December 5, 1962, the date of Wohl's death, against a security of $393.00? If he does, I cannot agree with him. Surely he does not deem this Court that commercially naive.

On the issue of the depletion or the diminution of the debtor's assets the reasoning and conclusion is obvious. If the assignment is held void, then on Wohl's death on December 5, 1962, Hygrade would be entitled to receive the proceeds thereof and they would have been available to Hygrade's creditors or on adjudication to the trustee.

I therefore hold that as a matter of law the trustee has proved all of the elements required for a preference to be voided under the provisions of Section 60 of the Bankruptcy Act and that consequently the trustee would be entitled to judgment on his counterclaim.

As to the right of offset by Gibralter I have found that the additional advances were not made against the assigned insurance and also that these advances were not made "in good faith and without security of any kind." The right of setoff is similar to a counterclaim. On a counterclaim the proponent has the burden of proof and so here Gibralter has the burden of proving the elements

prerequisite to a setoff as provided in Section 60(c) of the Bankruptcy Act. The fact is that Gibralter's other security was present and available in the form of inventory liens, chattel mortgages and accounts receivable.

Its counsel makes much of Gibralter's continuing inventory lien by virtue of the agreement dated February 8, 1960 and section 45 of the Personal Property Law of the State of New York as well as a general continuing lien on all accounts receivable, pending and newly generated by the manufacture and sale of inventory, in his memorandum of law filed herein on March 28, 1967. At page 3 he contends, "it follows therefore that the accounts receivable assigned *subsequent* to the assignment of the life insurance policy were part of and *related back* to the original factor's lien." (Italics supplied.)

So I say that it follows therefore that the subsequent advances were made against those same securities.

On the element of good faith the factor is found wanting. Admittedly, Wohl was the "key man". Without him the firm was a mere shell as evidenced by the business vacuum created upon and after his death. Mrs. DeJoseph's testimony was to the effect that after the death of Wohl, the business came to a practical standstill. While she was kept on in the office doing all of the office work, including the bookkeeper's work, who died in the latter part of November, 1962 and the last payroll was on December 23, 1962. While she was kept on until sometime in January 1963 remittances of invoices were prepared by Gibralter employees and Hygrade mail was picked up by Gibralter employees. Notwithstanding this fact Gibralter continued to make advances to Hygrade after Wohl's death, six advances from December 17, 1962 to January 23, 1963, totaling $14,817. I cannot perceive how these advances while the business was in its death throes could possibly serve the interests of Hygrade. The undeniable motive for these ad-

vances under these circumstances, was to assure, if possible the collection of the accounts receivable. It was tantamont to Gibralter lending money to itself. So much so that one of the checks dated January 23, 1963 for $1,500, which was included in the additional advances, was given by Gibralter to Sam H. Lipson, the attorney for the bankrupt who filed the original Chapter XI petition. Mr. Lipson's testimony indicates minimal contact with his client but conferences with Gibralter's officers concerning insolvency proceedings.

The Court of Appeals has already found that under the circumstances and conditions that existed on November 26, 1962 the factor had reason to believe that the debtor was insolvent. A prerequisite of good faith is provided by the set-off provisions of Section 60(8). The giving of advances on November 26, when as a matter of law Gibralter should have known that the bankrupt was insolvent, the continuing of advances thereafter, after the death of Wohl on December 5, when Gibralter had actual knowledge because of its employees contact with Hygrade's office employees that the business had come to a standstill and that the factory had been closed, all point to the lack of good faith on the factor's part.

I therefore find that the Factor-Creditor, Gibralter, had security of another kind for the additional advances and that the additional advances were not made in good faith and I conclude as a matter of law that Gibralter is not entitled to a set-off against the claim of the trustee to the proceeds of the insurance.

Burlingham v. Crouse, 228 U.S. 459 is not authority for the limitation of the amount of recovery to the cash surrender value under circumstances similar to this case. In Burlingham the Court in the first instance was passing upon the question of whether in any event the policy would pass to the trustee under Section 70a(5). The policies in

suit, at the time of petition filed, having no cash surrender value and no value of any kind were merely executory contracts and were not property or a property right which the trustees in bankruptcy were entitled to take. Burlingham, if anywise here applicable, is applicable to the extent that the Court there considered the value "at the time of petition filed." Page 464. In our case the value was not $393, the cash surrender value at the time of the assignment, but $101,000, the proceeds of the policy, since Wohl had died on December 5, 1962 and the petition was filed later and the value at the time of petition filed is the value that governs.

The other case relied upon for the same contention is U. S. versus Bess, 357 US 51. That case is also not apposite since the Government's lien for unpaid income tax against the assured had attached prior to his death; the beneficiary was liable only to the extent of the cash surrender value of his policies.

The recovery of the trustee here, if any, should be to the extent of $101,000.

To recapitulate, I find as a matter of law that the policy was exempt property and not recoverable as a preference by the trustee and the counterclaim of the trustee is dismissed. If upon review or appeal it is held that the proceeds of the policy are recoverable by the trustee, the counterclaim is allowed in the sum of $101,000 without any set-off to Gibralter.

This is an order.

Dated, Brooklyn, New York
April 17, 1967.

JOSEPH V. COSTA
Referee in Bankruptcy

Decision of Judge Walter E. Bruchhausen Confirming Order of Referee in Bankruptcy, Joseph V. Costa, Dated December 6, 1965

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF NEW YORK

[SAME TITLE]

The trustee seeks a review of the order of the referee in bankruptcy Hon. Joseph V. Costa. The order entered on October 18, 1965 denied the trustee's requested relief in its answer and counterclaim setting aside alleged preferential transfers.

A careful analysis and consideration of the record clearly establishes that the referee's decision is sufficiently supported by the record and the applicable law. The petitioner's position is untenable.

The referee's findings and orders are confirmed.

Settle order on two days notice.

WALTER BRUCHHAUSEN
U.S.D.J.

Opinion and Order of District Judge Weinstein Dated August 8, 1967

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF NEW YORK

[SAME TITLE]

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WEINSTEIN, *D.J.*

Review is sought of the determination of the Referee in Bankruptcy following remand by the Court of Appeals for further findings and conclusions. See *In re Hygrade Envelope Corp.*, 366 F. 2d 584, 589 (2d Cir. 1966). The question posed is whether the $101,000 proceeds of an insurance policy—on the life of Jack Wohl, vice-president, general manager and "key man" of the bankrupt, Hygrade—assigned by Hygrade to Gibraltar Factors Corp. at a time when Hygrade was known to be insolvent, is a voidable preference. For the reasons indicated below, this Court

concludes, as did the Referee, that Gibraltar may retain the proceeds.

I. Relationship of Hygrade and Gibraltar

For a period of some years Hygrade, an "undercapitalized" firm, was financed by Gibraltar. Hurwitz, March 22, 1965, p. 137. The parties did not have an "old-line" or classical factoring relationship in which the factor purchases accounts outright and assumes the risk of loss. Steiner & Shapiro, Money and Banking, p. 237 (3rd Ed. 1963); Guthmann & Dougall, Corporate Financial Policy, pp. 470-473 (4th Ed. 1962). Rather, the financing arrangement involved loans of up to 75% of the net amount of the accounts receivable secured by the accounts, and loans secured by inventory liens. See Accounts Receivable Agreement dated December 8, 1959; Inventory Lien Agreement dated February 8, 1960. Such loans on inventory and other assets are part of the general services offered by modern factors. Phelps, The Role of Factoring in Modern Business Finance, p. 16 (1956); Bradley, Fundamentals of Corporation Financing, pp. 426-427 (1959).

At the initiation of their relationship, Gibraltar had required Hygrade to take out and assign to it insurance on Wohl's life in the sum of $100,000. Because one of the policies was a reducing one, it had a face value of only $72,000 in November of 1962. Hurwitz, October 30, 1963, p. 15.

On November 26, 1962, Hygrade was indebted to Gibraltar for $385,000 (figures are rounded off to nearest thouand). This debt was well in excess of the reliable security then held by Gibraltar. Lutsky, March 22, 1965, pp. 75 et seq. Gibraltar held security assignments of $61,000 in chattel mortgages and $273,000 in accounts receivable.

Some $144,000 of the assigned accounts were over 120 days old and considered by a court appointed auditor to be "doubtful." *Id.* at p. 77. An additional $62,000 of security in a fire loss claim and in inventory was available to pay loans on the accounts receivable because of cross-collateral agreements.

A few days before November 26, 1962, Gibraltar in a routine spot check of selected accounts discovered that Hygrade's second largest account indicated a "discrepancy". Confronted, Wohl revealed that these accounts included "pre-billed" goods not yet ordered.

At this point, Gibraltar sought further protection. It demanded an additional $100,000 insurance policy on the life of Wohl. Hygrade, not wishing to pay an estimated $1,000 necessary to purchase a new $100,000 policy on Wohl's life, assigned to Gibraltar, on November 26, 1962, such a policy owned by it with a cash surrender value of $393. Hurwitz, October 30, 1963, p. 15; Hurwitz, March 22, 1965, pp. 143-44.

From November 26, 1962 to February 8, 1967, the date Hygrade was adjudicated a bankrupt, Gibraltar continued to finance Hygrade. The loans and security assignments—listed below—indicate a narrower margin of security than the "up to 75% of the Net Amount of the Accounts assigned as security for each loan" provided by the Accounts Receivable Agreement. There was an obvious reliance on the continued managerial skill of Wohl, at least until he died "suddenly" on December 5, 1962 beneath the wheels of a train.

Opinion and Order of District Judge Weinstein

DEALINGS BETWEEN HYGRADE & GIBRALTAR

11/26/62-2/8/63

	Security Taken	*Loans Made*
11/26/62	Insurance policy (cash surrender value $393; proceeds on death $101,000) Chattel Mortgage—$15,000	$12,500
11/27/62	Accounts Receivable—$5,951.12 Chattel Mortgage—$8,500	6,200
11/28/62		2,000
11/29/62	Accounts Receivable—$8,042.49	4,000
12/ 1/62	Accounts Receivable—$8,038.23	13,000
12/ 5/62	(Death of Wohl)	
12/17/62	Accounts Receivable—$12,426.65	8,484
12/21/62	Accounts Receivable—$3,590.03	2,700
1/ 2/63	Accounts Receivable—$2,711.14	2,033
1/23/63	(petition in bankruptcy filed)	1,500
Total	$64,259.66 (exclusive of life insurance policy)	$52,417

During this two month period there were substantial collections against assigned accounts receivable so that, despite additional loans, the net debt was reduced to $210,000. After collection of $101,000 on the insurance policy in question and other adjustments, there is still a deficit of some $50,000 in the account due from Hygrade to Gibraltar. Hurwitz, March 22, 1965, p. 147.

II. Litigation Involving Proceeds of Policy

The trustee in bankruptcy counterclaimed for the proceeds of the insurance policy as a voidable preference. The Referee, finding a failure of proof that "at the time of the assignment of the insurance policy Gibraltar knew or had reasonable cause to believe that the bankrupt was insolvent," denied relief. Decision of Referee, September 30, 1965. This order was confirmed by Bruchhausen, J. Unpublished opinion, December 13, 1965.

The Court of Appeals reversed because "the result does not jibe with the applicable rule of law" and "was infected by a misreading of the record." *In re Hygrade Envelope Corp.*, 366 F. 2d 584, 588-89 (2d Cir. 1966). The case was remanded to the Referee to determine the following issues:

> ". . . whether the transfer was for or on account of an antecedent debt, §60a(1), and whether, if the transfer was preferential, Gibraltar is entitled to a set off under §60c. He may also consider the claim, first advanced in Gibraltar's petition for rehearing, that the trustee is not entitled to recover because the insurance policy was exempt property under New York Insurance Law §166(1) if that point remains relevant in the light of his other findings and conclusions." *Ibid.*

Upon remand, the Referee concluded "as a matter of law that the insurance policy in question is exempt property covered by Sec. 166(1) of the Insurance Law of the State of New York and that the trustee cannot void the assignment thereof as a voidable preference under any of the applicable sections of the Bankruptcy Act." Referee's Decision, April 17, 1967, p. 18. The Referee made the fol-

lowing additional findings—relevant only if his finding regarding the exempt status of the insurance policy is reversed: "the transfer of the insurance policy, from Hygrade to Gibraltar, was a preference within the purview of Section 60B of the Bankruptcy Act and was not made for a new and present consideration but was additional security for a past indebtedness." *Id.* at p. 19. The Referee further concluded that inasmuch as "Gibraltar, had security of another kind for the additional advances and that the additional advances were not made in good faith . . . I conclude as a matter of law that Gibraltar is not entitled to a set-off against the claim of the trustee to the proceeds of the insurance." *Id* at p. 27.

III. Exempt Status of Insurance Policy

The Federal Bankruptcy Act itself contains no exemptions for the property of bankrupts. Instead, section 6 (11 U. S. C. §24) grants "bankrupts . . . the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition." Since federally created exemptions are not relevant here, the "Bankruptcy Law . . . makes the state laws . . . the measure of the right to exemptions" of the bankrupt. *White* v. *Stump*, 266 U. S. 310, 312 (1924). "Whether the exemption claimed . . . should or should not have been allowed must, therefore, be determined by the laws of [the] state." *Turner* v. *Bovee*, 92 F. 2d 791, 793 (9th Cir. 1937). But, of course, even if the state law permits the exemption, it also must be one allowable under the federal law.

Paragraph 1 of section 166 of the Insurance Law of New York grants an assignee [Gibraltar] of a life insurance policy the "proceeds or avails" [$101,000] "as against" a

trustee in bankruptcy of the "person effecting the insurance" [Hygrade]. It provides as follows:

> "§166. *Exemption of proceeds and avails of certain insurance and annuity contracts.*
>
> 1. If any policy of insurance has been or shall be effected by any person on his own life in favor of a third person beneficiary, or made payable, by assignment, change of beneficiary or otherwise, to a third person, such third person beneficiary, assignee or payee shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person effecting the insurance. If any policy of insurance has been or shall be effected by any person upon the life of another person in favor of the person effecting the same or made payable, by assignment, change of beneficiary or otherwise, to such person, the latter shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person insured; if the person effecting such insurance shall be the wife of the insured, she shall be entitled to the proceeds and avails of such policy as against her own creditors, trustees in bankruptcy and receivers in state and federal courts. *If any policy of insurance has been or shall be effected by any person on the life of another person in favor of a third person beneficiary, or made payable, to a third person, such third person beneficiary, assignee or payee shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives,*

> *trustee in bankruptcy and receivers in state and federal courts of the person insured and of the person effecting the insurance.* . . . The person insured in a case under the first sentence of this subsection or the person effecting the insurance other than the wife of the insured in a case under the second sentence, and the person effecting the insurance under the third sentence thereof, or the executor or administrator of any such persons, or a person entitled to the proceeds or avails of such policy in trust for such persons shall not be deemed a third person, beneficiary, assignee or payee. . . ." (Emphasis supplied.)

The exemption provided by state law does not apply in this case for two independent and sufficient reasons. First, the Bankruptcy Act requires that the property be exempt when in Hygrade's hands and under the state statute it is exempt, at best, only in Gibraltar's. Second, under the state law, the exemption is not available to a corporation.

A. *Exemption Not Possible Under Federal Law*

Exemptions under state law apply "[o]nly in such event" as "an exemption to the bankrupt within the provision of section 6 of the Bankruptcy Law" is allowed. *In re Messinger,* 29 F. 2d 158, 160 (2d Cir. 1928), *cert. denied,* 279 U. S. 855 (1928). Section 6 allows exemptions solely to "bankrupts." See 3 Remington on Bankruptcy, §1281 (1956). Three possible exceptions exist to this federal rule. "An exemption may be claimed by the bankrupt's wife and children, when the state law permits it, as the intention of the law is as much to protect them as the husband." 1 Collier on Bankruptcy, §6.09, pp. 828-9 (14th

Ed. 1966). Partners may be able to claim exemptions in partnership assets. *Id.* at p. 832. Lastly, an assignee of property exempt in the hands of the bankrupt may retain it even if it otherwise would be a preference. See *Rutledge* v. *Johansen*, 270 F. 2d 881, 883 (10th Cir. 1959) (transfer by bankrupt of exempt homestead); *In re Rubin*, 29 F. Supp. 416, 418 (S. D. N. Y. 1939) (transfer of exempt insurance proceeds; "The money thus received being exempt, the bankrupt's estate was not diminished and the creditors have sustained no loss").

Gibraltar cannot, under the federal law, qualify for an exemption in its own right since it is not a bankrupt. There is no exemption allowed Hygrade, the bankrupt, under any construction of subdivision 1 of section 166 of New York's Insurance Law. The first sentence of subdivision 1 only grants an exemption to persons insuring their own lives—not the circumstance here. The second sentence makes a grant only to creditors of the insured—Wohl's creditors—and his creditors are not claiming the exemption. See, *e.g.*, N. Y. Insurance Law §§146, 221-a, 601 ("insured" is the person whose life is covered). The third sentence exempts only third party beneficiaries and Hygrade—which bought the policy—was never the third party beneficiary. Hygrade could not, under Section 166, by effecting an insurance policy on the life of another receive an exemption against its own creditors.

B. *Exemption Not Granted by State Law*

Even if this strict interpretation of the Federal Bankruptcy Act is incorrect, the state law does not grant an exemption to corporations such as those in this case. The phrase "person effecting the policy" (Gibraltar), as used in the state statute, means "natural person." In construing "person" in Section 166 we look to New York State law.

Section 37 of the New York General Construction Law defines "person" to include a corporation. But, Section 110 of that Law provides that the definition will not apply if "the context of the language construed . . . indicate[s] that a different meaning or application was intended . . ."

The New York Insurance Law uses the term "person" inconsistently; sometimes "person" obviously includes a corporation; while at other times "persons" means only a natural person. *Compare e.g.*, §§146(2)(b), 148 *with* §§110, 118, 165.

The pattern of subdivision 1 of section 166 suggests that "person" does not include a corporation in this provision. The "person" affecting an insurance policy "on his own life" in the first sentence could only be a natural person. In the fifth sentence, reference is made to executors or administrators of the persons effecting the policy; corporations obviously do not qualify. But such mechanical grammatical exercises in statutory construction are seldom reassuring. Much more useful in interpretation is a search for the reason the rule was adopted.

The applicable state policy is protection of natural persons against want. "The exemption of a reasonable amount of property necessary to subsistence has long been recognized in this country as justifiable on humanitarian grounds." Baldwin's New York Insurance Law, p. 100 (1939). *Cf. Jackson* v. *Jackson,* 194 Misc. 134, 135, 86 N. Y. S. 2d 516, 517 (Sup. Ct. 1948) (the purpose of "such statutes" is to provide "support and maintenance"). As pointed out in a leading treatise (1 Collier on Bankruptcy, §6.03 (14th Ed. 1966)):

> "Courts have noted three distinct but related purposes served by exemption statutes: (1) protection

> of individuals and of families from pauperism during periods of financial difficulty; (2) encouragement for debtor rehabilitation; and (3) shifting of the burdens of social welfare from the community to creditors."

One noted authority has flatly declared that "[c]orporations do not have personal exemptions and the administration of their affairs is correspondingly simplified." MacLachlan, Law of Bankruptcy, p. 422 (1956). *Cf. Phillips* v. *C. Palono & Sons,* 270 F. 2d 791, 793 (5th Cir. 1959) (granting exemption to partners; contrasting liberal Texas exemption laws with more restrictive policy in other states).

Legislative history on this provision or its predecessor —former section 55-a—is scant. But it is significant that the only reference to its purpose contained in the bill jacket on file in the Legislative Reference Library in Albany is a comment from an insurance company trade association that "this law will provide real protection to all honest policy holders and their families." See also Insurance Department of New York, Insurance Law Revision of the State of New York Tentative Draft, 1937, p. 184.

While the matter is not free from doubt, the exemption of section 166 is not, this Court holds, available to a corporation. The decision of the Referee on this issue is reversed.

IV. Consideration for Assignment of Insurance Policy

Since Gibraltar is not entitled to an exemption, it is necessary to consider the issue remanded by the Court of Appeals for determination: "whether the transfer was for or on account of an antecedent debt" and, therefore, a

voidable preference pursuant to subdivision (a) of section 60 of the Bankruptcy Law. 11 U. S. C. §96(a). The essential elements of a voidable preference are: (1) a debtor making or suffering a transfer of its property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) while insolvent; (5) within four months of bankruptcy; (6) the effect of which transfer will be to enable the creditor to obtain a greater percentage of his debt than other creditors of his class; (7) the creditor being preferred has knowledge or reasonable cause to believe that the debtor was insolvent. *Moran Bros., Inc.* v. *Yinger,* 323 F. 2d 699, 701 (10th Cir. 1963); *Aulick* v. *Largent,* 295 F. 2d 41, 45 (4th Cir. 1961); 3 Collier on Bankruptcy, Section 60.02[1] (14th Ed. 1966). The absence of any one of these factors negates the existence of a voidable preference.

The Court of Appeals found that Gibraltar had reasonable cause to believe that Hygrade was insolvent. *In re Hygrade Envelope Corp.,* 366 F. 2d 584, 589 (2d Cir. 1966). There can be no substantial doubt that all other necessary elements of a voidable preference existed, with the exception of antecedent debt—item (3) in the above enumeration.

A transaction may be made between a debtor and a creditor even with full knowledge of insolvency provided that the transfer of property by the debtor was not "for or on account of" an antecedent debt. In the instant case, for example, the trustee properly failed to challenge the assignments of accounts receivable made after November 26, 1962, when Hygrade's insolvency became apparent, because it is clear that the advances thereafter made were fair consideration for the accounts received.

The reason that transfers subsequent to knowledge of insolvency are not all voidable is obvious. A transfer of the debtor's assets to a creditor after insolvency, it is recognized, may be for "the very purpose of assisting the bankrupt and helping him to extricate himself from the financial difficulties which had beset him, not to defraud, hinder, or delay his creditors." *United Pacific Insurance Co.* v. *United States,* 358 F. 2d 966, 970 (Ct. Cl. 1966). Security given by an insolvent to a creditor which advances funds in the hope that the debtor can continue in business is proper provided the "amount of the collateral was in no case excessive." *In re Freeman Cotting Coat,* 212 F. 548, 550 (D. Mass. 1913). Transfers made after the lender had reasonable cause to believe the bankrupt was insolvent are not preferential where the lender paid a "fair present consideration." *Wolf* v. *Aero Factors Corp.,* 212 F. 2d 291, 292 (2d Cir. 1955). The fact that continued financing might ultimately help collect past debts is not decisive. *Cf. Pasadena Investment Co.* v. *Pasadena Air Products, Inc.,* 234 F. Supp. 128, 134-35 (S. D. Cal. 1964) (overdrawn accounts were not antecedent debt and could represent "fair present consideration" for invoices assigned).

Their agreement did not obligate Gibraltar to continue to loan monies to Hygrade. On November 26, 1962, after the discovery of the "pre-billed" accounts, Gibraltar knew that it was owed more money than it held in security. It also recognized that if it stopped financing Hygrade that client would soon go out of business thereby possibly maximizing losses on accounts receivable. While continued financing might have meant throwing good money after bad, it was possible that the business could be saved, all debts paid, and a valuable client retained. One view of subsequent events was, therefore, that Gibraltar decided to

inject new money into the business with the hope of either saving it or of keeping it running long enough to reduce Gibraltar's losses as much as possible. The advances by Gibraltar after Wohl's death on December 5, 1962, may have been of a different kind, made "to assure, if possible, the collection of the accounts receivable." Referee's Decision, April 17, 1967, pp. 25-26.

Financing by factors has grown in recent years; they are now one of the major sources of business funds in the United States. See Bradley, Fundamentals of Corporation Financing, p. 427 (1959); Popma, a Behind-The-Scenes Look at Factoring, in Readings in Financial Management, p. 337 (Mock Ed. 1964) ("fastest growing form of business finance in the country"). While factors do not provide "a one-shot, distress type of operation," but normally a continuing arrangement (Phelps, The Role of Factoring in Modern Business Finance, p. 18 (1956)), they sometimes supply funds at critical points in the life of a business. When factors overreach to obtain impermissible preferences they must be forced to disgorge. But courts should not draw inferences with excessive reliance on hindsight to discourage such important sources of business capital from exercising their judgment to save concerns on the edge of failure. In the instant case, bankruptcy resulted, but in other cases, continued advances after "insolvency" have saved valuable business enterprises from destruction to the benefit of the creditors and others. The law must consider how reasonable business men might have analyzed the situation before committing their assets in this time of Hygrade's business crisis.

As Gibraltar's representative Hurwitz noted, after he made a "quick decision" (Hurwitz, March 22, 1965, p. 147) to continue financing, Wohl "would ask us to give him

these advances and we had to do a lot of soul searching each time." Hurwitz, October 30, 1963, p. 10. Due to increasing debts and a self reducing feature of one of the life insurance policies, the ratio of insurance coverage to debts had been substantially reduced by November, 1962. Hurwitz, March 22, 1965, p. 141. In view of the good will and executive skill of the business concentrated in the person of Wohl, it was reasonable and sound business practice for Gibraltar to have required insurance on Wohl's life. As one proponent of factoring points out, "We place greater emphasis on people than on the property they own. . . . Funds are granted to individuals on the basis of their individual capacities. This obviously involves a large element of risk." Popma, A Behind-The-Scenes Look at Factoring, in Readings in Financial Management, p. 337 (Mock Ed. 1964).

A clear insurable interest was present. See Harnett & Thornton, Insurable Interest in Property: A Socio-Economic Reevaluation of a Legal Concept, 48 Colum. L. Rev. 1162, 1169 (1948); 2 Appleman, Insurance Law and Practice, §852, p. 356 (1966). The insurance, while perhaps not in an accounting sense security for new advances, was security, in an economic sense, of the future value of the business as a going concern. It looked ahead, not behind. Embarking upon an open-ended program of financing of uncertain magnitude, particularly after the "pre-billing" affair, it was not unreasonable to demand additional insurance protection of $100,000—particularly where the actual cash surrender value of the policy assigned was only $393—less than 1% of the $52,000 advanced after November 26, 1962.

The testimony before the Referee with respect to the intentions of the parties is naturally somewhat confused and ambiguous since no one was able to ignore the past in-

debtedness as they negotiated for new financing. Nevertheless, a reading of the full record supports the conclusion that the assignment of the policy was taken as consideration for future financing of a business all hoped would be saved. For example, Herbert Hurwitz, vice-president of Gibraltar, testified as follows as to the assignment of the insurance policy:

> Q. Will you tell us whether this assignment of the insurance policy for $100,000 was made to replace the security of the accounts receivable which proved to be fictitious? A. No. . . . We continued to make them advances to continue them in business. Their business was to buy and process raw material, to convert it into a finished product and sell it and create a receivable. We thereby took an assignment of the receivables as consideration for additional services. Hurwitz, October 30, 1963, pp. 14-19.
>
> The Referee: Was that the item [discovery of prebilled accounts] that caused you to ask for what you might call additional security?
>
> The Witness: * * *
>
> Mr. Wohl had indicated that he would need our cooperation to continue because if we suddenly stopped advancing money to him he obviously would have a problem as to how he was going to get money.
>
> Of course, after looking over the file, insurance had been one of the items that came up. We had been doing business with Hygrade since 1955, in other words it was seven years we had been doing business with them and from the very first we had life insurance assigned to us. We had a $50,000 policy at one point and we had another $50,000 at

another point. As the account grew we would ask for more insurance.

One of the $50,000 policies was a reducing term policy and worth about $20,000 in November, 1962. We had at that time $27,000 face value of life insurance.

When Mr. Shulder looked at the account and saw he owed us $300,000 to $400,000, he insisted we get more life insurance and we conveyed this to Mr. Wohl.

We were going to take out a policy to cover ourselves when he said he had a policy and there was no need to incur additional premiums. The premium on $100,000 would be in the neighborhood of $1,000 and I asked him what he had and that he bring it in and we would take an assignment for it. He brought in this policy of $100,000. * * *

We gave him that loan and took the mortgage and at the same time took an assignment of the life insurance policy.

Hurwitz, March 22, 1965, pp. 130-132.

The Court is satisfied by the pattern of previous business dealings and the testimony and other evidence that the assignment of the insurance policy was obtained in order to induce Gibraltar to make further advances in what proved to be a vain attempt to keep Hygrade going as a business enterprise. Its assignment was not, in the words of the statute "for or on account of an antecedent debt". The decision of the Referee on this issue is reversed.

V. Value of Policy

Even if the policy were assigned as consideration for past debts, the trustee would not be entitled to the $101,000 proceeds of the policy but to the value at the time of as-

signment. The value of a preference is approached from two points of view. First, the market value of the assets at the moment of the assignment; and, second, the extent of the depletion of the bankrupt's estate at that moment. *Virginia National Bank* v. *Woodson,* 329 F. 2d 836, 840 (4th Cir. 1964). See also *Continental & Commercial Trust & Savings Bank* v. *Chicago Title & Trust Co.,* 229 U. S. 435, 444 (1913) (estate of bankrupt must be diminished).

Both these approaches require a determination of value at the time of assignment, not at the time of the contingency precipitating payment. *In re P. B. McChesney & Son,* 31 F. Supp. 202, 204 (W. D. Ky. 1940). *Cf. In re Schindler,* 223 F. Supp. 512, 529 (E. D. Mo. 1963). "The character of the transactions is to be judged at the time when they were made, not by how the collateral panned out afterwards." *In re Freeman Cotting Coat Co.,* 212 F. 548, 550 (D. Mass. 1913). Where market value is used valuation must be on the basis of what the bankrupt would be able to obtain . . . at a fair sale." *Mansfield Lumber* v. *Sternberg,* 38 F. 2d 614, 618 (8th Cir. 1930). Except in the case of a unique asset whose value in the hands of the bankrupt is greater than it would be in the market—and this insurance policy was not unique in that sense—the value lost by the bankrupt is the fair sale value.

At the time of transfer, the policy was no more valuable than a New York State lottery ticket a month before the drawing—even if that ticket ultimately proved to be the winning one. *Cf. In re Little River Lumber Co.,* 92 F. 585, 587 (W. D. Ark. 1899) (the policy was "not assets like notes, mortgages, and other choses in action, to which creditors could look for security. Indeed, the company could not collect them. There had been no loss, and their collection depended on the loss"). See also *In re Freeman*

Cotting Coat Co., supra, (assignee collected an excess of collateral on assigned accounts, all of which proved good).

What the bankrupt lost at the moment of assignment was only what it would have then had available for distribution had it not made the transfer. There is no evidence in the record that Wohl was not in average health (Teigman, March 22, 1965, p. 38) or that Gibraltar was determined to secure Wohl's death or drive him to take his own life. The value at the time of assignment was either $393 or $1,000. The lower figure was the cash surrender value or what the policy could be sold for. The higher figure was the cost of a new policy.

In the absence of any bankruptcy cases valuing life insurance policies, we look to the internal revenue laws for analogies. But *cf. Burlingham* v. *Crouse,* 228 U. S. 459, 472 (1913) (under §70(a) of Bankruptcy Act, cash surrender value is decisive). When a taxpayer claims a loss upon the surrender of a life insurance policy, "market value" of the policy surrendered is determined. *Early* v. *Atkinson,* 175 F. 2d 118, 122 (4th Cir. 1949). This is the cash surrender value. *London Shoe Co.* v. *Commissioner,* 80 F. 2d 230, 233 (2d Cir. 1935), *cert. denied,* 298 U. S. 663 (1936) (value of the surrendered policy was its cash surrender value inasmuch as premiums above such value were "paid to obtain the insurance protection which was for many years afforded"). See also *Gravois Planning Mill Co.* v. *Commissioner,* 299 F. 2d 199, 211 (8th Cir. 1962) ("it was at the time worth no more than cash surrender value to [assignee] which was otherwise short of immediately needed cash"); *Early* v. *Atkinson, supra; Arnold* v. *United States,* 180 F. Supp. 746 (N. D. Tex. 1959). *Cf. United States* v. *Bess,* 357 U. S. 51, 55-56 (1958) lien during lifetime of beneficiary is based on cash surrender value; government cannot reach face value upon death). For gift tax purposes, where the gain to the donee is an

important factor, the replacement cost of the policies is the proper value because "[t]he cost of duplicating the policies at the dates of the gift is, in the absence of more cogent evidence, the one criterion which reflects both their insurance and investment value to the owner at that time". *United States* v. *Ryerson*, 312 U. S. 260, 261 (1941).

The relationship of Gibraltar to Hygrade was not that of donee and donor so that the taxpayer surrender cases rather than the gift cases seem to provide a closer analogy. The Court, therefore, finds the value of the policy at the time of assignment to be $393. The decision of the Referee on this issue is reversed.

But whether the value is $393 or $1,000, compared to the total debts owed to Gibraltar and the amounts subsequently advanced, the amount is de minimis. 3 Collier, Bankruptcy, ¶60.02, p. 860, n. 8 (14th Ed. 1965). Even if this assignment constituted a preference—and it does not—in the circumstances of this case, there is no necessity to set it aside.

VI. Set Off

The claim of Gibraltar for a set off under paragraph (8) of subdivision (c) of section 60 of the Bankruptcy Act was denied by the Referee. The conclusion of the Referee that Gibraltar was not entitled to a set off is affirmed.

VIII. Conclusion

The decision of the Referee that the proceeds of the policy in the sum of $101,000 are not recoverable, is affirmed.

So ordered.

Dated: Brooklyn, New York
August 8, 1967

Decision of United States Court of Appeals for the Second Circuit Dated September 28, 1966

No. 375—September Term, 1965.

Docket No. 30319

In the Matter of Hygrade Envelope Corp.,

Bankrupt,

SAMUEL S. BARANOW, Trustee in Bankruptcy of Hygrade Envelope Corp.,

Appellant,

—v.—

GIBRALTAR FACTORS CORP.,

Respondent.

Before:

LUMBARD, *Chief Judge,* and
MOORE and FRIENDLY, *Circuit Judges.*

On Petition for Rehearing

PER CURIAM:

By petition for rehearing respondent Gibraltar calls our attention to a statement of the Referee that in view of his conclusion of lack of reasonable cause by Gibraltar to believe Hygrade was insolvent, which we reversed, he had not passed on the issues whether the transfer was "for or on account of an antecedent debt," as required by §60a(1), and whether Gibraltar might be entitled to a set-off under §60c. It also advances a point which, so far as we can determine, was never argued to anyone, namely, that the policy on Wohl's life was exempt property under New

York Insurance Law §166(1), and that its proceeds were therefore not recoverable despite the proviso to §6 of the Bankruptcy Act. We would ordinarily not be disposed to consider an argument raised for the first time on petition for rehearing; however, since a remand is required in any event and we are not satisfied that the arguments presented in the petition for rehearing, the answer and the reply are adequate for proper disposition of the point by us at this juncture, we leave open this issue also.

The opinion is therefore modified (1) by adding to the last on p. 2627 the words "and remanded," (2) by striking from the last four lines on p. 2628 the words "while the transfer had all the elements of a preference as defined in §60a(1) of the Bankruptcy Act, a conclusion not here challenged," and (3) by amending the last sentence on p. 2636 to read:

> "The order is reversed and the cause remanded so that the referee may make further findings and conclusions on the issues, reserved by him, whether the transfer was for or on account of an antecedent debt, §60a(1), and whether, if the transfer was preferential, Gibraltar is entitled to a set off under §60c. He may also consider the claim, first advanced in Gibraltar's petition for rehearing, that the trustee is not entitled to recover because the insurance policy was exempt property under New York Insurance Law §166(1) if that point remains relevant in the light of his other findings and conclusions."

Decision of United States Court of Appeals for the Second Circuit Dated July 13, 1966

No. 375—September Term, 1965.

(Argued May 5, 1966 Decided July 13, 1966.)

Docket No. 30319

In the Matter of

HYGRADE ENVELOPE CORP.,

Bankrupt.

SAMUEL S. BARANOW, Trustee in Bankruptcy of HYGRADE ENVELOPE CORP.,

Appellant,

—v.—

GIBRALTAR FACTORS CORP.,

Respondent.

Before:

LUMBARD, *Chief Judge*,
MOORE and FRIENDLY, *Circuit Judges*.

Appeal from an order of the District Court for the Eastern District of New York, Walter Bruchhausen, *Judge*, affirming an order of a referee in bankruptcy which dismissed a counterclaim by a trustee alleging that a creditor had received a preferential transfer. Reversed.

ABRAHAM L. POPPER (Popper & Popper, New York, N. Y.), *for Appellant*.

LOUIS P. ROSENBERG, Brooklyn, N. Y. *for Respondent*.

Decision of United States Court of Appeals, July 13, 1966

FRIENDLY, *Circuit Judge*:

Hygrade Envelope Corp. was adjudicated a bankrupt in the District Court for the Eastern District of New York pursuant to an involuntary petition filed January 24, 1963. For many years it had been financed by Gibraltar Factors Corp. under an arrangement by which Gibraltar took as security assignments of its accounts receivable; in November 1962 Hygrade owed Gibraltar more than $300,000. The key man in Hygrade was its vice president and general manager, Jack Wohl. Gibraltar required Hygrade to take out and assign to it insurance on his life, originally $100,000 but, because one of the policies was a reducing one, only $72,000 in the autumn of 1962. On November 26, 1962, for reasons recounted below, Gibraltar demanded additional insurance and was assigned another $100,000 term policy on Wohl's life. Although this had a surrender value of only $393, it rapidly matured as a result of his death on December 5 in consequence of a sudden fall from the platform of a station in the path of an oncoming train.

When Gibraltar moved in the bankruptcy court for an order permitting it to take possession of certain machinery of Hygrade on which it held a chattel mortgage, the trustee counterclaimed that the transfer of the insurance policy was a voidable preference. The referee found that while the transfer had all the elements of a preference as defined in §60a (1) of the Bankruptcy Act, a conclusion not here challenged, the trustee had failed to establish that at the time Gibraltar had reasonable cause to believe Hygrade was insolvent as required by §60b. Accordingly he dismissed the counterclaim; on a petition to review by the trustee, the district court affirmed in a short memorandum.

Because of Whol's death the trustee was forced to develop his case almost entirely out of the mouth of Gibraltar, specifically Herbert Hurwitz, a vice president who had much to do with the Hygrade account. Hurwitz' testimony, first given at examinations under §21a and elaborated at trial, disclosed that Gibraltar's practice was to verify the accounts receivable assigned by Hygrade by making monthly spot-checks with selected purchasers. When, a few days before November 26, it sought to make such a verification with Avrick & Co., one of the largest accounts,[1] the report "came back indicating a discrepancy." Gibraltar immediately summoned Wohl to explain this. He admitted that the assigned Avrick accounts represented goods it had not yet ordered, and also that there were other accounts he had similarly "pre-billed" so that "the amounts shown as due and owing on our books were not in fact due and owing."[2] Hurwitz discussed the situation with his superior who reviewed the file. They decided not to make further inquiry because, as Hurwitz testified, "For us to have called all his accounts at that time would have been to disrupt his entire business and cause a catastrophe

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[1] Hygrade's receivable statement showed $53,639 owing from Avrick out of a total of $265,561; only one account, for $57,946, was larger. There were only a half dozen accounts which ran into five figures; these comprised approximately 80% of the total.

[2] As Hurwitz stated in his 21a examination,

> "when we called Mr. Wohl to account for this, to the effect that there were bills assigned to us were not bona fide, he came to our office and admitted that he had assigned bills which had not come into being yet. We tried to ascertain the extent of that but were unable to do so. He claimed he did not know himself but that he would in due time work everything out and he asked us to please go along with him because if we would cease factoring or financing him at the time it would catapult the business into bankruptcy."

as far as he and we were concerned." Finding that the insurance on Wohl's life, which originally had covered the full line of credit, had become a relatively small fraction of the amount owed, they resolved that Gibraltar must get more insurance. With the $100,000 policy assigned, Gibraltar then made further advances, the first, for $12,500, being secured by a chattel mortgage of $15,000 on equipment, and others, aggregating almost $40,000, being secured by the assignment of accounts receivable represented by invoices of actual shipments.

A preference is clearly voidable under §60b "when such a state of facts is brought to the creditor's notice, respecting the affairs and pecuniary condition of the debtor, as would lead a prudent business person to the conclusion that the debtor is insolvent," 3 Collier, Bankruptcy ¶60.53, at 1057-58 (14th ed. 1964). The statute moreover has been properly read as going somewhat beyond this and to preclude a creditor from deliberately closing his eyes so as to remain in ignorance of the debtor's condition; "where circumstances are such as would incite a man of ordinary prudence to make inquiry, the creditor is chargeable with notice of all facts which a reasonably diligent inquiry would have disclosed" and "an inquiry of the debtor alone is generally insufficient." *Id.* at 1063-65. We have approved this principle in many cases. See, e.g., *Levy* v. *Weinberg & Holman, Inc.*, 20 F. 2d 565, 567 (2 Cir. 1927); *Pender* v. *Chatham Phenix Nat. Bank & Trust Co.*, 58 F. 2d 968, 970 (2 Cir. 1932); *Margolis* v. *Gem Factors Corp.*, 201 F. 2d 803, 805 (2 Cir. 1953); *Robinson* v. *Commercial Bank of North America*, 320 F. 2d 106, 107-08 (2 Cir. 1963). Knowledge that a debtor securing advances by assignment of accounts receivable had deliberately written up one of its largest accounts to include goods the customer was merely expected to order would beyond doubt incite a man of

ordinary prudence to make inquiry. See *Margolis* v. *Gem Factors Corp., supra,* 201 F. 2d at 805. There could scarcely be a clearer case for considering inquiry of the debtor to be insufficient than where it acknowledged the falsification discovered by the creditor was not the only instance and where this was found in one of the largest accounts. The man of ordinary prudence would at least have proceeded to verify the six big accounts, see fn. 1, and very likely would have insisted on a check of all customers of any significance. What inquiry would have revealed is indicated by Hurwitz' testimony that after Hygrade closed in December and outstanding accounts were collected, there were still some $155,886 in supposed receivables from apparently solvent purchasers on which Gibraltar expected to realize only $10,000. Once such extensive "machinations"—using Hurwitz' expression—had been discovered, a complete audit which would have revealed that Hygrade was insolvent would surely have followed.

Gibraltar insists that, however all this may seem to us, we must follow the contrary finding of the referee, affirmed by the district court, unless we are prepared to brand this as "clearly erroneous." See *In re Slocum,* 22 F. 2d 282, 285-86 (2 Cir. 1927); *In re Melnick,* ——F. 2d —— (2 Cir. 1966), slip opinions 1817. There are indeed a multitude of opinions proclaiming, in one way or another, the applicability of the "unless clearly erroneous" rule, see F. R. Civ. P. 52(a), to decisions of a referee or district judge that a creditor did or didn't have reasonable cause to believe his debtor was insolvent. See, e.g., *McDougal* v. *Central Union Conference Ass'n,* 110 F. 2d 939, 942 (10 Cir. 1940); *Harrison* v. *Merchants Nat. Bank,* 124 F. 2d 871, 874 (8 Cir. 1942); *Bostian* v. *Levich,* 134 F. 2d 284,

286-87 (8 Cir. 1943); *Security-First Nat. Bank* v. *Quittner*, 176 F. 2d 997, 999 (9 Cir. 1949); *Norberg* v. *Ryan*, 193 F. 2d 407, 409 (9 Cir. 1951). It is not difficult, however, to assemble an equally impressive list of cases from this and the Fifth Circuit in which courts of appeals have reversed determinations as to reasonable cause without obeisance to the "unless clearly erroneous" principle. *Levy* v. *Weinberg & Holman, Inc., supra*, 20 F. 2d 565; *Pender* v. *Chatham Phenix Nat. Bank & Trust Co., supra*, 58 F. 2d 968; *Marks* v. *Goodyear Rubber Sundries Co.*, 238 F. 2d 533 (2 Cir. 1956); *Mayo* v. *Pioneer Bank & Trust Co.*, 297 F. 2d 392, 395 (5 Cir. 1961); *Clower* v. *First State Bank*, 343 F. 2d 808 (5 Cir. 1965). Such seeming and largely unexplained [3] contrariety of decision suggests the need for further analysis.

Determination whether a creditor had reasonable cause to believe his debtor was insolvent is a two-step process. First the court must determine what the creditor knew; then it must apply the rules as to the legal consequences of what he knew. The first step is indeed a question of fact. A typical illustration is resolving a conflict in testimony, as when a bankrupt insists that he told the creditor he was being forced to close down and the creditor denies it; another is determining the creditor's knowledge by a factual inference, as when a bankrupt's poor financial condition has been bruited about in the trade, the creditor denies having heard of it, but his conduct, e.g., in pressing for more than usual security, suggests that he had. Both the resolution of conflicting testimony and the drawing of factual inferences from circumstantial evidence are protected by the "unless clearly erroneous" rule. See *C. I. R.* v. *Duberstein*,

[3] Judge Wisdom's opinion in the *Mayo* case, which does confront the problem, arrives at a solution not basically different from ours.

363 U. S. 278, 291 (1960). At the opposite end of the spectrum, the courts, in developing glosses on the statute relating to the duty of inquiry and the nature of the inquiry demanded, have been pursuing their usual function of interstitial law making. An appellate court would not hesitate to reverse a referee or district judge who refused to find reasonable cause to believe in insolvency because he openly insisted on reading §60b as limited to knowledge the creditor actually had rather than knowledge he ought to have had. The case should not stand differently as to review when a referee or judge, while not in terms disputing the relevant legal rules, has reached a result not truly consistent with them.

Whether application of a legal standard to facts that are undisputed or have been found without clear error is a question of law or of fact is, as we said in *Ellerman Lines, Ltd.* v. *The S.S. President Harding,* 288 F. 2d 288, 292 (2 Cir. 1961), "an area over which 'law' and 'fact' have battled for a century." See also *NLRB* v. *Marcus Trucking Co.,* 286 F. 2d 583, 590 (2 Cir. 1961). Perhaps clarity of thought would be promoted by recognizing that it is not exactly one or the other. Jural concepts are not limited to binary systems. The scope of review might be better understood by recognizing that the imperatives of F. R. Civ. P. 52(a) and its analogues are avoided whenever the issue is not one of "fact"; there is no necessity for going further and endeavoring to establish that it is one of "law" in the usual meaning of that term. Once this is understood, appellate courts can formulate such standards of review, subject, of course, to governing legislation, as comport with good sense and institutional allocations of power. This is why the degree of appellate abnegation toward the application of law to fact differs according to the identity

of the fact finder, ranging from the jury, through the administrative agency, see *NLRB* v. *Marcus Trust Co., supra,* 286 F. 2d at 590-92, to another judicial officer. In the last case the institutional considerations operate within a single discipline and, as we have recently noted, there are substantial reasons, particularly relating to consistency of decision, that dictate rather full review. *Mamiye Bros.* v. *Barber S.S. Lines, Inc.* —— F. 2d ——, —— (2 Cir. 1966), slip opinions 1565 at 1568-72. To be sure, an appellate court must respect findings of the trial judge as to what in fact happened and in addition should give due weight to his superior opportunity to acquire the true feel of the case, cf. *Cone* v. *West Virginia Paper Co.,* 330 U. S. 212, 216 (1947). But when the issue is his application of a legal standard to facts undisputed or reasonably found, reversal is not limited to results that are "clearly erroneous"; it is enough that the appellate court should be convinced, as we are here, that the result does not jibe with the applicable rule of law.[4]

Almost all the cases cited above in which appellate courts have deferred to findings of a referee or judge with respect to reasonable cause to believe in a debtor's insolvency are reconcilable with this approach; the reviewing court, in invoking the "unless clearly erroneous" rule, has simply paid proper respect to the trier's determination of credibility or resolution of evidential conflicts. See also *Coder* v. *Arts,* 152 Fed. 943, 946 (8 Cir. 1907), aff'd, 213 U. S. 223 (1909),

[4] Although reversal in such a case could often be deemed justified under the principle that the "unless clearly erroneous" rules does not protect when the reviewing court has "the definite and firm conviction that a mistake has been committed," *United States* v. *United States Gypsum Co.,* 333 U. S. 364, 394-95 (1948), clarity is promoted by recognizing that the application of a legal standard to the facts is not a "finding of fact" within the rule.

quoted with approval in *Brookheim* v. *Greenbaum*, 225 Fed. 763, 764 (2 Cir. 1915). The single exception is *Security-First Nat. Bank* v. *Quittner, supra,* in which Judge Pope declared that "even where there is no doubt or controversy as to what facts came to the attention of the creditor, the question as to whether he acted reasonably in making no further inquiries, in short, whether he had reasonable cause to believe the debtor insolvent is generally a question of fact." 176 F. 2d at 999. Such a broad holding, though deriving some support from two of the older circuit court decisions cited,[5] did not take account of the authority in the courts of appeals looking the other way; and the Supreme Court pronouncement relied upon, *Grand Trunk Ry.* v. *Ives*, 144 U. S. 408, 417 (1892), dealt with what, for reasons indicated, we regard as the quite different question of the respect owed to a jury's application of law to fact. The *Security-First Nat. Bank* holding is indeed consistent with the Ninth Circuit's general view that a judge's decision on the issue of reasonable care is a finding of fact protected by the "unless clearly erroneous" rule, see *Pacific Tow Boat Co.* v. *States Marine Corp.*, 276 F. 2d 745, 752 & n. 12 (9 Cir. 1960), and cases cited. But we have adhered to our long held contrary position in face of that court's disapproval, see *Romero* v. *Garcia & Diaz, Inc.*, 286 F. 2d 347, 355-56, cert. denied, 365 U. S. 869 (1961), and *Ellerman Lines, Ltd.* v. *The S.S. President Harding*, 288 F. 2d 288, 291-92 (1961), and have reaffirmed our view as recently as *Mamiye Bros.* v. *Barber S.S. Lines, Inc., supra.*

A further reason for not regarding ourselves as bound by the referee's finding in this case is that it was infected by a misreading of the record. Apparently irked at what

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[5] *Boston Nat. Bank* v. *Early*, 17 F. 2d 691 (1 Cir. 1927); *In re Eggert*, 102 Fed. 735 (7 Cir. 1900).

he deemed an effort by the trustee's counsel to put more into Hurwitz' mouth than Hurwitz had said, the referee ended up by putting in considerably less. After reciting testimony by a bookkeeper that sometimes a customer would be billed immediately on order and without awaiting delivery and that this constituted "pre-billing," the referee stated:

> "The record is replete with insistence by Hurwitz both in his testimony before me and in his 21a examination transcripts in evidence that Wohl informed him that the Avrec account was a pre-billed account, that Avrec was a regular customer with which Hygrade had dealt and was still dealing with, that this was the only one to Hurwitz's knowledge on November 26, 1962, although after November 26, 1962 Wohl told him about other pre-billed accounts."

But the record is utterly clear that on November 26 Wohl told Hurwitz that Avrick was not the only pre-billed account and that he used the term to refer not to the rather bland practice described by the bookkeeper but to a writing up of accounts in the mere expectation of future orders.[6] Since the quoted finding of fact was thus clearly erroneous, the conclusion the referee drew from it can stand no better.

The order is reversed with instructions to direct allowance of the trustee's counterclaim.

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[6] The latter conclusion is compelled by Hurwitz' testimony repeatedly characterizing Wohl's pre-billing as "fraudulent" and "not bona fide," as contrasted with his acknowledgment that in a hold-for-shipping order the fact that the goods are held by the seller "does not mean it is not a bona fide invoice."

Decision of United States Court of Appeals for the Second Circuit Dated April 1, 1968

No. 267—September Term, 1967.

(Argued February 19, 1968 Decided April 1, 1968.)

Docket No. 31766

In the Matter of

HYGRADE ENVELOPE CORP.,

Bankrupt.

SAMUEL S. BARANOW, Trustee in Bankruptcy of HYGRADE ENVELOPE CORP.,

Appellant,

—v.—

GIBRALTAR FACTORS CORP.,

Respondent.

Before:

FRIENDLY and SMITH, *Circuit Judges*, and GIGNOUX, *District Judge*.*

Appeal by a trustee in bankruptcy from an order of the District Court for the Eastern District of New York, Jack B. Weinstein, *Judge*, which disallowed the trustee's counter-claim to recover as a preference $101,000 in proceeds of an assigned life insurance policy and dismissed the creditor's claim for a set-off. Order reversed with

* Of the District Court of Maine, sitting by designation.

instructions to allow the counterclaim subject to reduction as stated in the opinion.

ABRAHAM L. POPPER (Popper & Popper, New York, N. Y.; William I. Popper, on brief), *for Appellant.*

LOUIS P. ROSENBERG, Brooklyn, N. Y. (Sydney Krause, on brief), *for Respondent.*

FRIENDLY, *Circuit Judge*:

Hygrade Envelope Corp. was adjudicated a bankrupt in the District Court for the Eastern District of New York on a voluntary petition filed on January 24, 1963. On November 26, 1962, it had transferred to Gibraltar Factors Corp. a term insurance policy in the face amount of $100,000 on the life of its vice president and general manager, Jack Wohl.[1] A referee in bankruptcy and the district court initially rejected a counterclaim by the trustee under §60b to recover as a preference the proceeds of the policy, $101,000, collected by Gibraltar as a result of Wohl's sudden death on December 5, 1962, on the ground that Gibraltar did not have "reasonable cause to believe" Hygrade was insolvent on November 26. On a previous appeal the Court of Appeals disagreed and remanded the cause "so that the referee may make further findings and conclusions on the issues, reserved by him, whether the transfer was for or on account of an antecedent debt, §60a(1), and whether, if the transfer was preferential

[1] Apparently the policy had cost $1000 but its cash surrender value had declined to $393 due to the lapse of time.

Gibraltar is entitled to a set off under §60c," as well as the claim, first advanced on Gibraltar's petition for rehearing in this court, "that the trustee is not entitled to recover because the insurance policy was exempt property under New York Insurance Law §166(1). . . ." 366 F. 2d 584, 589-90 (2 Cir. 1966).

The case returned to the Court of Appeals with reaffirmance of the dismissal of the trustee's counterclaim by the same referee and a different district judge but with sharp disagreement between them as to the reason. The referee sustained the argument that the proceeds of the policy were within the exemption conferred by §6 of the Bankruptcy Act; he thought, however, that apart from this "the trustee has proved all of the elements required for a preference to be voided under the provision of Section 60 of the Bankruptcy Act and that consequently the trustee would be entitled to judgment on his counterclaim," free of any set-off by Gibraltar for advances subsequent to November 26, 1962. The district judge concluded that the policy was not exempt but held that the transfer was not "for or on account of an antecedent debt," and that in any event the transfer was only in the amount of $393, the sum Hygrade would have realized on surrender of the policy, or at most $1000, the cost of a new one-year policy, and should be disregarded as *de minimis*.

I.

Gibraltar's contention with respect to exemption rests on the third sentence of §166-1 of the New York Insurance Law which we quote in the margin.[2] Judge Weinstein

[2] "§166. *Exemption of proceeds and avails of certain insurance and annuity contracts.*

(footnote continued on next page)

ruled that the phrase "effected by any person" applies only to natural persons despite §37 of New York's General Construction Law defining "person" to include a corporation, and that in any event Gibraltar could not take advantage of "the allowances to bankrupts which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the

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(footnote continued from previous page)

1. If any policy of insurance has been or shall be effected by any person on his own life in favor of a third person beneficiary, or made payable, by assignment, change of beneficiary or otherwise, to a third person, such third person beneficiary, assignee or payee shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person effecting the insurance. If any policy of insurance has been or shall be effected by any person upon the life of another person in favor of the person effecting the same or made payable, by assignment, change of beneficiary or otherwise, to such person, the latter shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person insured; if the person effecting such insurance shall be the wife of the insured, she shall be entitled to the proceeds and avails of such policy as against her own creditors, trustees in bankruptcy and receivers in state and federal courts. *If any policy of insurance has been or shall be effected by any person on the life of another person in favor of a third person beneficiary, or made payable, by assignment, change of beneficiary or otherwise, to a third person, such third person beneficiary, assignee or payee shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person insured and of the person affecting the insurance.* . . . The person insured in a case under the first sentence of this subsection or the person effecting the insurance other than the wife of the insured in a case under the second sentence, and the person effecting the insurance under the third sentence thereof, or the executor or administrator of any such persons, or a person entitled to the proceeds or avails of such policy in trust for such persons shall not be deemed a third person beneficiary, assignee or payee . . . . " (Emphasis supplied.)

petition in the State wherein they have had their domicile . . . ," authorized by §6 of the Bankruptcy Act. Agreeing with the latter ruling we have no occasion to pass upon the former.

If Hygrade had not assigned the policy, no exemption could have been asserted since the second sentence of §166-1, which would then have been the only basis for one, exempts the policy from the claims of the creditors and personal representatives of the person insured (here Wohl) rather than of creditors of its owner. Gibraltar thus cannot take advantage of the principle that an assignee of exempt property may have the benefit of the exemption accorded by §6 since the estate otherwise available to creditors will not be diminished by the assignment. See *Rutledge* v. *Johansen,* 270 F. 2d 881, 883 (10 Cir. 1959); 1 Collier, Bankruptcy ¶6.11 (1967). On the face of things, would seem incongruous that a policy not exempt in the bankrupt's hands should become so when preferentially assigned to a creditor, as would be rather apparent if the policy here had possessed a substantial cash surrender value. If New York intended to accomplish any such result, as a literal reading of the third sentence of §166-1 might suggest, it meant to do something Congress did not allow. Section 6 of the Bankruptcy Act is limited to allowances "to bankrupts" and while we have expanded this to include members of the bankrupt's immediate family who have been named as beneficiaries, see *In re Messinger,* 29 F. 2d 158 (2 Cir. 1928), cert. denied, 279 U. S. 655 (1929); *Schwartz* v. *Holman,* 68 F. 2d 814 (2 Cir.), cert. denied, 293 U. S. 565 (1934); *In re Keil,* 88 F. 2d 7 (2 Cir. 1937); *Schwartz* v. *Seldon,* 153 F. 2d 334 (2 Cir. 1945), we know of no principle and have not been informed of any precedent that would justify ex-

panding the exemption Congress allowed "to bankrupts" so as to include a policy of life insurance, not exempted by state law for the bankrupt, when this is in the hands of an unrelated person.

II.

The referee thought that because of the new security taken by Gibraltar for advances made to Hygrade after November 26, 1962, the assignment of the insurance policy was solely "for or on account of" the then existing indebtedness of between $300,000 and $400,000 which was only partially secured. The district judge reached an opposite conclusion, "that the assignment of the policy was taken as consideration for future financing of a business all hoped would be saved." If the understanding was in fact that the policy should constitute security only for new advances, we fail to perceive how Gibraltar could be allowed to use the proceeds to secure old ones. What seems entirely plain is that the parties made no such sharp distinctions as have now been attributed to them; the insurance policy was meant to secure advances both old and new according as need might arise.

While application of the proceeds of the policy to repayment of fresh advances made in reliance thereon would not constitute a voidable preference, their application to the payment of antecedent debts would, see 3 Collier, Bankruptcy ¶60.19 at 855 (1967), subject only to the point concerning the amount of the transfer we will next consider. Save for that, the case is indistinguishable from the many holdings that where the fair value of security given by the debtor exceeds the new loan, there is a voidable preference —assuming the other elements exist—insofar as the security is applied in satisfaction of an antecedent debt. See, e.g.,

Auleck v. *Largent*, 295 F. 2d 41, 45 (4 Cir. 1961); *United Pacific Insurance Co.* v. *United States*, 358 F. 2d 966 (Ct. Cl. 1966); *In re Sindler*, 223 F. Supp. 512 (E. D. Mo. 1963); MacLachlan, Bankruptcy, 292-93 (1956); 4 Remington, Bankruptcy, §1661.3 (1957)

III.

Gibraltar's next line of defense, sustained by the district judge, is that any transfer to it was so minuscule in amount as not to constitute a preference. It argues that there would have been no preference if it had bought the policy for $393, which indeed it could have included as a financing charge so that no money would have had to pass, and that the depletion effected by the assignment cannot have been greater than this or, at most, the $1000 required to buy a replacement policy. This concentration on the situation as of November 26 gives insufficient weight to the final portion of the definition of a preferential transfer in §60a(1), to wit, "the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class." *Palmer Clay Co.* v. *Brown*, 297 U. S. 227, 229 (1936), teaches that under this language "Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results." See 3 Collier, Bankruptcy ¶60.35 and ¶60.36. *Continental & C. T. & S. Bank* v. *Chicago T. & Savings Co.*, 229 U. S. 435 (1913), relied upon by Gibraltar, stands only for the undoubted proposition that the challenged transfer must deplete the estate to be preferential; it nowhere indicates

that depletion should be measured at the time of the transfer. *Virginia National Bank* v. *Woodson*, 329 F. 2d 836 (4 Cir. 1964), also cited by Gibraltar, may be similarly distinguished.[3] Moreover, the trustee's position accords with the equities as we view them. On November 26, 1962, Gibraltar knew the continuance of Hygrade's business to be parlous at best. It knew also that everything depended on Wohl; according to Gibraltar's vice president, when Wohl sought continued advances, "we told him we would want additional insurance on his life because he was the key man in the business and without him we felt the business would not continue," as proved all too true. Gibraltar must have realized that Wohl's life was equally important to other creditors, who would have shared in the proceeds of the $100,000 policy as matters stood. Yet Gibraltar took this valuable asset for itself, knowing that no replacement would be provided. Under such circumstances it cannot be heard in equity to say it was preferred only to the extent of $393 or $1000, representing actuarial averages, when the very event it feared and to protect against which it took an assignment of the policy, to the detriment of other creditors, occurred nine days later. The case is the unusual one where "market value" affords no real indication of an asset's worth.

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[3] While the only district court case at all in point, *In re Little River Lumber Co.*, 92 Fed. 585 (W. D. Ark. 1899), dealing with fire insurance policies payable to a creditor and apparently covering property not subject to a valid lien held by him, does rule in Gibraltar's favor, its reasoning, predicated upon the general validity of equitable liens in bankruptcy, is no longer acceptable, see §60(a)(6). On the other hand, if policies validly made payable to specified creditors are *renewed* in the four month pre-bankruptcy period pursuant to an earlier agreement, the transaction would not be preferential as the substitution of collateral rationale, developed later in this opinion, would apply. Cf. *Sullivan* v. *Meyer*, 137 Tenn. 412, 193 S. W. 124 (1917).

There is even less merit in Gibraltar's further argument that §60(b) limits the trustee's recovery to the policy's cash surrender value. The statute grants the trustee the right to recover "the property" transferred preferentially, or, if it has been "converted," its value. A policy is not "converted" within the meaning of the statute by the mere fact that it matures. See 3 Collier, Bankruptcy ¶60.59. The trustee emphasizes that if Wohl had died a bit later or the adjudication had occurred a bit earlier, he could have recovered the policy itself ("the property") prior to Gibraltar's collection of it. We do not understand why Wohl's early death and collection of the proceeds by the preferred creditor should bring about a different result.

IV.

Gibraltar's claim that it is entitled under §60c to set off against the trustee's counterclaim advances between November 26, 1962 and January 23, 1963, in the sum of $60,917, requires little discussion. That section provides:

> "If a creditor has been preferred, and afterwards in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him."

We see no reason to doubt that Gibraltar's actions, designed to keep Hygrade afloat, were "in good faith," *Kaufman* v. *Tredway*, 195 U. S. 271 (1904); *Grandison* v. *First Nat. Bank of Commerce*, 231 Fed. 800 (2 Cir.), cert. denied, 242 U. S. 644 (1916); 2 Collier, Bankruptcy ¶60.67

at 1138. But the advances were not made "without security of any kind"; to the contrary, the district judge's opinion lists security of $64,259.66 exclusive of the life insurance policy.

However, there is more to Gibraltar's argument than this. The assignment of the insurance policy was not a voidable preference insofar as Gibraltar made advances after November 26 in reliance thereon and needed to resort to the proceeds of the policy for their payment. We have already indicated that the policy was assigned to secure advances both old and new, and the record is clear that in making future advances, particularly after Wohl's death on December 5, Gibraltar relied on everything that it had. Hence, if for example the "new" security taken for the $60,917 of new advances was worth only $30,000, there could be no question under the circumstances of Gibraltar's right to use $30,917 of the insurance proceeds to satisfy its post-November 26 claims. See §60(a)(8). The results should be the same insofar as preexisting arrangements permitted security avowedly given for post-November 26 advances to be applied to antecedent debts without constituting a voidable preference despite Gibraltar's reasonable cause to believe in Hygrade's insolvency. There is reason to think some of the "new" security fits that description.

We start with the earliest case: Included in the list of new security furnished by Hygrade are two chattel mortgages executed on November 26 and 27 in the face amount of $23,500. Examination of the schedules attached to the mortgage of November 26 indicates that in fact almost all the chattels listed had been mortgaged to Gibraltar on December 18, 1960. To that extent Gibraltar is entitled to have the value of the mortgaged chattels applied to

antecedent debts and look to the insurance proceeds, if need be, for payment of later advances.[4]

The other "new" security stated to have been obtained by Gibraltar consisted of $41,759.66 in accounts receivable. The factoring agreement of February 8, 1960, which was duly filed, gave Gibraltar a lien both upon existing and future inventory and upon "all the accounts receivable and other proceeds resulting from the sale or other disposition of such merchandise." So far as the accounts receivable are concerned, this agreement gave Gibraltar no more than an equitable lien upon the future accounts as they arose, which would have been inferior to the lien of an attaching judgment creditor. See *Okin* v. *Goldman*, 79 F. 2d 317 (2 Cir. 1935); *Rockmore* v. *Lehman*, 128 F. 2d 564 (2 Cir. 1942), rev'd on rehearing, 129 F. 2d 892, cert. denied 317 U. S. 700 (1943); *Matter of City of New York* v. *Bedford Bar & Grill*, 2 N. Y. 2d 429 (1957). It was only when the factor satisfied the further requirement imposed by §45 of the New York Personal Property Law, then in effect, and either notified the account debtor "that the account is payable to the lienor," or secured an additional assignment, that the lien became "so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee . . . ," see §60(a)(2). Since the transfer of the $41,759.66 in accounts was "perfected" within the four months period and after Gibraltar had reasonable cause to believe Hygrade was insolvent, it is preferential if applied to antecedent debts. To allow the factor's lien to attach to inventory coming into Hygrade's possession after Novem-

[4] The mortgage of November 27 is not part of the record on this appeal. It should, of course, be treated in the same way.

ber 26 as security for such debts would be similarly preferential. *Zartman* v. *First Nat'l Bank*, 189 N. Y. 267 (1907); *Irving Trust Co.* v. *Commercial Factors Corp.*, 68 F. 2d 864, 868-69 (2 Cir. 1934).

The factor's lien would therefore assist Gibraltar only so far as a substitution of collateral theory might apply, see 3 Collier, Bankruptcy ¶60.21 and cases cited. If, for example, $10,000 in pre-November 26 inventory were sold on December 10, Gibraltar clearly would have the right to substitute as security for an antecedent debt new accounts receivable or inventory to which its lien attached between November 26 and December 10. *In re Pusey, Maynes, Breish Co.*, 122 F. 2d 606, 608 (3 Cir. 1941) (Goodrich, *J.*). There would be more of a problem if Gibraltar should seek to "substitute" for inventory that was thus sold the account receivable resulting from its sale. The problem would be that, on our reading of ¶45, Gibraltar's lien on this account would be perfected only when it secured an additional assignment or notified the account debtor—and this could occur only after December 10. Under old cases the new security could not be properly "substituted" for the old on the ground that replacement was not "contemporaneous." *In re Lambert & Braceland Co.*, 29 F. 2d 758 (E. D. Pa. 1928); *In re Baumgartner*, 55 F. 2d 1041 (7 Cir. 1931). However, it has been persuasively argued by commentators on the "floating lien" provisions of the Uniform Commercial Code, Note, After Acquired Property Security Interests in Bankruptcy: A Substitution of Collateral Defense of the U. C. C., 77 Yale L. J. 139, 151-58 (1967); 1 Coogan, Hogan & Vagts, Secured Transactions under the Uniform Commercial Code, 1084-85 (1966); 2 Gilmore, Security Interests in Personal Property 1315-16 (1965), that this requirement was based

upon the principle of *Benedict* v. *Ratner*, 268 U. S. 353 (1925), which, as the author of that opinion recognized, does not apply to liens authorized by New York's Factor's Act. *Id.* at 361 n. 11; *In re Cut Rate Furniture Co.*, 163 F. Supp. 360 (N. D. N. Y. 1958); *Colbath* v. *Mechanics National Bank*, 96 N. H. 110, 70 A. 2d 608 (1950) (construing New Hampshire's Factor's Act derived from the New York statute); 1 Gilmore, *supra*, §8.8 (1965); but see Zinman, Dominion and the Factor's Lien, 30 Ford. L. Rev. 50 (1961). Since Gibraltar, by policing its collateral strictly, could have perfected its lien on the accounts receivable as soon as the merchandise had been sold, it may substitute post-November 26 accounts receivable as security for antecedent debts to the extent that its inventory lien had been depleted by subsequent sales. The record, however, does not permit us to determine whether pre-November 26 inventory was in fact sold, and, if so, in what amount.

We hold that Gibraltar may retain so much, if any, of the proceeds of the policy on Wohl's life as is required to pay its post-November 26 loans to Hygrade after applying to them all post-November 26 security except (1) the value of property covered by the chattel mortgages of November 26 and 27 which in fact was already validly mortgaged to it, and (2) post-November 26 accounts receivable and inventory, if any, which merely replaced similar security held on that date. The balance of the proceeds is payable to the trustee. The judgment disallowing the trustee's counterclaim is therefore reversed and the cause remanded to the district court with instructions to remand to the referee for further proceedings consistent with this opinion. Each party shall pay its own costs on appeal.

Order of United States Court of Appeals for the Second Circuit Dated July 13, 1966

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of July one thousand nine hundred and sixty-six.

Present:

HON. J. EDWARD LUMBARD,
Chief Judge,
HON. LEONARD P. MOORE,
HON. HENRY J. FRIENDLY,
Circuit Judges.

In the Matter of

HYGRADE ENVELOPE CORPORATION,
Bankrupt,

SAMUEL S. BARANOW,
Trustee-Appellant.

Appeal from the United States District Court for the Eastern District of New York.

This cause come on to be heard on the transcript of record from the United States District Court for the Eastern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is reversed with instructions to direct allowance of the trustee's counterclaim in accordance with the opinion of this court with costs to the appellant.

A. DANIEL FUSARO
Clerk

By VINCENT A. CARLIN
Chief Deputy Clerk

Order of United States Court of Appeals, Second Circuit, Dated September 28, 1966

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-eighth day of September, one thousand nine hundred and sixty-six.

Present:

HON. J. EDWARD LUMBARD,
Chief Judge,
HON. LEONARD P. MOORE,
HON. HENRY J. FRIENDLY,
Circuit Judges.

In the Matter of

HYGRADE ENVELOPE CORPORATION,
Bankrupt,

SAMUEL S. BARANOW,
Trustee-Appellant.

A petition for rehearing having been filed herein by counsel for the appellee, Gibraltar Factors Corp.,

Upon consideration thereof, it is

Ordered that the opinion and judgment of this court of July 13, 1966 be and they hereby are amended in accordance with the opinion of this court of September 28, 1966.

A. DANIEL FUSARO
Clerk

Order of United States Court of Appeals for the Second Circuit Dated April 1, 1968

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the first day of April one thousand nine hundred and sixty-eight.

Present:

HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
Circuit Judges,

HON. EDWARD T. GIGNOUX,
District Judge.

In the Matter of

HYGRADE ENVELOPE CORPORATION,
Bankrupt,

SAMUEL S. BARANOW,
Trustee-Appellant,

GIBRALTER FACTORS CORPORATION,
Respondent-Appellee.

Appeal from the United States District Court for the Eastern District of New York.

Order of United States Court of Appeals, April 1, 1968

This cause came on to be heard on the transcript of record from the United States District Court for the Eastern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged and decreed that the order disallowing the trustee's counterclaim be and it hereby is reversed and that the action be and it hereby is remanded to said District Court with instructions to remand to the referee for further proceedings consistent with this opinion and that each party shall bear its own costs on appeal in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk